lancashire
HOLDINGS LIMITED

Fetch

ANNUAL REPORT 2006

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2006 FINANCIAL HIGHLIGHTS

- Fully converted book value per share grows 17.4%
- Operating income of $180.5 million[(1)] or $0.89[(2)] per common share
- Profit after tax of $159.3 million or $0.79[(3)] per common share
- Gross written premiums of $626.0 million
- Loss ratio of 16.1%
- Combined ratio of 44.3%
- Capital retained for 2007 opportunities

OPERATING HIGHLIGHTS

- Successful transition from start-up to fully established major underwriter
- Excellent response to launch of UK underwriting platform
- Authorisation received for Middle East marketing operation
- Highly experienced team of 57 people across the Group

POSITIVE OUTLOOK FOR 2007

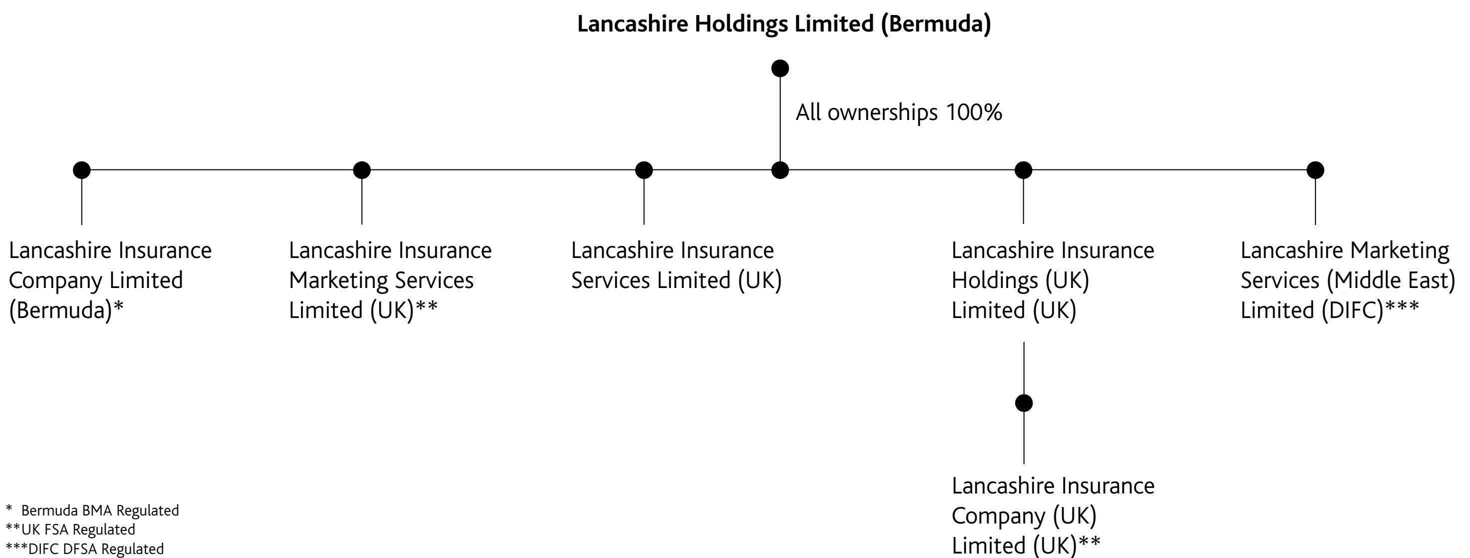
- Capital expected to be fully utilised in 2007
- Overall trading conditions very healthy and business flow accelerating
- January 1, 2007 net unearned premium reserve of $306.6 million
- Projected 2007 gross written premium growth of at least 20%
- Projected 2007 growth in book value of between 20% and 25%, assuming normal market loss experience

(1) Operating income is profit before tax, excluding realised investment gains and losses, foreign exchange and warrants issued at IPO, but inclusive of options issued thereafter.

(2) Net operating income per common share of £0.48, using an average 2006 exchange rate.

(3) Profit after tax per common share of £0.42, using an average 2006 exchange rate.

GROUP OPERATING STRUCTURE



Lancashire Holdings Limited and its subsidiaries (the "Group") are providers of global property insurance and reinsurance products. Lancashire Holdings Limited ("Lancashire" or the "Company") was incorporated under the laws of Bermuda on October 12, 2005. Lancashire is listed on the Alternative Investment Market ("AIM"), a subsidiary market of the London Stock Exchange. The registered office of Lancashire is Clarendon House, 2 Church Street, Hamilton HM 11, Bermuda. Lancashire has five wholly owned subsidiaries: Lancashire Insurance Company Limited ("LICL"), Lancashire Insurance Holdings (UK) Limited ("LIHUKL"), Lancashire Insurance Marketing Services Limited ("LIMSL"), Lancashire Insurance Services Limited ("LISL") and Lancashire Marketing Services (Middle East) Limited ("LMSMEL"). LIHUKL is a holding company for a wholly owned operating subsidiary, Lancashire Insurance Company (UK) Limited ("LICUKL").

LICL and LICUKL are currently the Group's principal operating subsidiaries. LICL was incorporated under the laws of Bermuda on October 28, 2005 and is authorised by the Bermuda Monetary Authority (the "BMA") as a Class 4 general insurer. LICL provides insurance and reinsurance products to its customers, with an emphasis on property, energy, marine and aviation lines of business. LICUKL was incorporated under the laws of England & Wales on March 17, 2006 and is authorised by the United Kingdom Financial Services Authority (the "FSA") to conduct general insurance business. The products provided are the same as those provided by LICL. LICUKL is also registered as a Class 3 general insurer in Bermuda and has a permit issued under the Bermuda Companies Act to enable certain activities related to its insurance business to be performed from Bermuda.

LIMSL is authorised by the FSA to undertake insurance mediation activities. LIMSL provides business introduction and other support services to LICL in the United Kingdom, and was incorporated under the laws of England & Wales on October 7, 2005.

LISL was incorporated under the laws of England & Wales on March 17, 2006. LISL provides support services to LIMSL and LICUKL.

LMSMEL was incorporated under the laws of the Dubai International Financial Centre ("DIFC") on March 11, 2007 and is authorised by the Dubai Financial Services Authority ("DFSA") to undertake insurance intermediation activities.

Underwriting comes first

This is your Chairman's first opportunity to report since Lancashire both launched and listed in late 2005. It is particularly pleasing to do so after the Company has achieved so much in its first full year of operations. The Company began 2006 with a Bermuda underwriting license, only four full time employees and two very small rented offices. By the end of the year, a full infrastructure had been built, over $600 million in gross premiums had been written, a separate UK FSA licensed insurer had been launched, and book value had grown 17.4%. A remarkable achievement.

After its first year, Lancashire has emerged as a highly focused and successful business.

Market expectations for the 'Class of 2005' were for Bermuda reinsurers writing predominantly cat cover. Lancashire is somewhat different. We write a diversified mix of insurance and reinsurance, both cat and non-cat, across many specialty lines, from twin underwriting platforms in Bermuda and London. Underwriting teams in both locations are experienced and operate under the same mandate – risk selection is key. As a result, we can boast not only today's excellent results, but also a wealth of business relationships with brokers and clients that will give us strength to grow over the years ahead.

SHARE OFFERING

On December 16, 2005 Lancashire completed its private placement and initial public offering and the Company's common shares began trading on the Alternative Investment Market of the London Stock Exchange. A total of $979 million was raised, net of offering expenses. We received an excellent response from investors, both during and following the offering.

DIVIDEND POLICY

At this time, the Board does not recommend the payment of a dividend. Given the underwriting opportunities in front of us right now, we believe the Company can effectively utilise all of its capital for the benefit of shareholders in the current market environment. Capital management is an area under constant analysis. Should a time come where underwriting opportunities decrease, we are committed to returning excess capital to shareholders through dividends or any other tools at our disposal.

BOARD OF DIRECTORS

Your Board of Directors has performed valuable service during the first year of the Company's life. In September 2006, we welcomed Martin Thomas to the Board as a non-executive independent Director. Martin brings with him a wealth of legal and regulatory experience which has proven extremely useful, particularly with the launch of our London based underwriting operation. The Board and the nomination committee intend to review the composition of the Board and consider any need for additional Directors during 2007.

OUTLOOK

Lancashire's number one operating principle is "Underwriting Comes First". Already, Richard Brindle and his team have done an outstanding job in executing this strategy. It is a pleasure to work with Richard and the entire Lancashire staff. I thank them for their dedication and enthusiasm and I look forward to working with them in 2007 and beyond.

ROBERT SPASS, CHAIRMAN

Our first year

We were pleased to grow book value by over 17% in our first year.

I am delighted to report that 2006, our first full year of business, was a success both financially and operationally. Financially, we increased fully converted book value per share by 17.4% from a standing start. We achieved a low combined ratio of 44.3% and generated net income of $159.3 million. Net operating income was $180.5 million and shareholders' equity grew by $190.5 million to a year end total of $1,137.6 million. Operationally, we have gone from being a start-up company to an established major underwriter in the market with sophisticated technical capabilities, a highly experienced underwriting team and 57 people across Bermuda, London and Dubai. In 2007, broker and client support remains extremely strong and the acceleration in business flow has been remarkable.

Our strategy is built on four cornerstones: (i) underwriting comes first; (ii) maintenance of a strong balance sheet; (iii) keep operations nimble; and (iv) management of capital through the cycle. We believe this strategy, successfully executed, will deliver our overriding aim of creating attractive long term growth in book value per share for our shareholders.

Lancashire primarily writes insurance with a focus on short-tail, specialty risks, mostly written on a direct basis. All things equal, we prefer writing direct risks as opposed to reinsuring someone else's book as we believe this approach can create a durable competitive advantage. Insurance involves the creation of direct sustainable relationships with our insured clients and a focus on specific risk selection which should improve the probability of success through hard and soft cycles.

Reinsurance can however offer compelling opportunities from time to time. For example, in 2006 we enthusiastically capitalised on such opportunities in property retrocession, and this will continue in 2007. However, reinsurance tends to be more of a commodity business where achieving a meaningful competitive advantage is difficult. With insurance underwriting, the critical success factor is risk selection. Skills in risk selection take experience, and our underwriting team is highly experienced. In our major lines of business, the team leaders have, on average, almost twenty years of experience. By consistently being smart about risk selection – through hard and soft cycles – Lancashire can sustain a competitive advantage. This competitive advantage should produce a better than expected loss ratio, and thus strong growth in book value per share over time.

We believe Lancashire can trade strongly in a hard market and a soft market. First, our book is mostly direct. Secondly, it is highly diversified. In 2007, we expect that over half of our premium will be generated from risks that are not exposed to natural catastrophes. We have deliberately built a diversified book of non correlating risks. This has been enhanced by our presence in three strategic locations – Bermuda, London and Dubai – giving us access to the business flow that is generated in each of these markets. The benefit of our diversified book is that in the future we can direct our capital to the best underwriting opportunities. This flexibility – combined with underwriting discipline – will allow us to trade successfully through all stages of the cycle. It also sets us apart from many more concentrated (re)insurers in Bermuda and elsewhere.

17.4%
GROWTH IN BOOK VALUE

$159.3m
NET INCOME

Rather than follow a rigid path, we are going to stay nimble and let the market guide us.

We like the book of business created in 2006. At the start of the year pricing was good in many areas and, as we anticipated, pricing and terms steadily improved through the year. Our enthusiasm increased correspondingly, as did our book. This rosy picture was not uniform though. In certain areas, most notably marine, pricing failed to reach expectations and we declined deals in large numbers. This reduced our top line premium but, crucially, resulted in a stronger portfolio of risks as we ended the year.

We wrote $626.0 million of gross premium in 2006. With the wealth of experience of our underwriting team, significant increases in policy submission count, and very good trading conditions, we expect to increase gross written premiums by at least 20% in 2007. This is based on current expectations for pricing and terms in lines that we target.

2007 has begun well. Loss experience to date has been lower than expected. The most significant industry loss has been the Kyrill wind storm which hit Europe in January. While we have received only a de minimis amount of advices, because of the inherent uncertainties surrounding such events we are currently estimating an impact to Lancashire of between zero and ten million dollars.

CAPITAL MANAGEMENT

To generate attractive long term returns for shareholders, we seek to couple excellent underwriting with conservative, active capital management. First, we intend to maintain a strong balance sheet at all times no matter what. Secondly, we will aim to have both the right level and mix of capital to support our underwriting.

In 2006, we grew capital by $190.5 million and, by the end of the year, our capital was fully deployed. Looking ahead, we are encouraged by the trading conditions in our markets. We believe we can deploy all of our capital and, absent major losses, do not anticipate any capital actions during the bulk of 2007. We are currently projecting book value per share growth in 2007 in the low to mid twenties percent range, assuming a normal level of losses and premium growth in line with expectations.

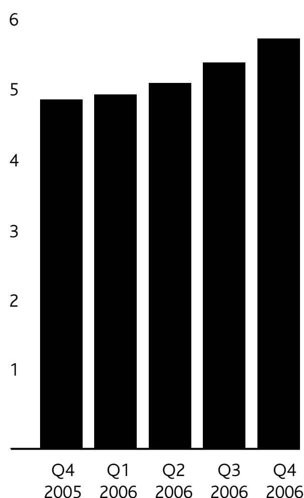
Following the end of the 2007 hurricane season, we will re-evaluate our capital requirements, giving careful consideration to balance sheet strength, rating agencies and other stakeholders. We expect that our combination of underwriting discipline and careful trading through the cycle will result in significant returns of capital in the future, as and when appropriate.

RICHARD BRINDLE, CHIEF EXECUTIVE OFFICER

Our first year – in numbers

The main aim for Lancashire is to achieve an above-average return for shareholders.

FULLY CONVERTED BOOK VALUE PER SHARE ($)



COMMENT ON RESULTS AND OUTLOOK

Gross written premiums for the twelve month period were $626.0 million. Overall trading conditions in the classes written by Lancashire have been very good. This, combined with the lack of any significant loss events in 2006, has resulted in a healthy operating income of $180.5 million and an overall combined ratio of 44.3%. We move into 2007 well placed to build on our existing book and relationships, and the increases in deal flow compared to a year ago have been significant. Our presence in the London market, through our FSA authorised insurer, has been well received. To date, 2007 renewals have been at encouraging prices and terms. Overall trading conditions are excellent. We are experiencing a gradual softening in certain areas from the peaks of summer 2006, but overall cat-pricing remains ahead of a year ago. We believe rates and conditions will hold strong in our major lines for the majority of 2007.

UNDERWRITING

Lancashire writes a highly diversified book of business, mostly on a direct basis, in four lines: property, energy, marine and aviation. In 2007, we expect our overall portfolio to grow but remain broadly similar in composition to that of 2006. In 2006, premium for risks exposed to natural catastrophes represented approximately 58% of our total written premium. For 2007, we expect this elemental proportion to reduce below 50%.

PROPERTY

This segment includes direct commercial property insurance and terrorism, all written on a facultative basis, as well as property cat retrocession. We have also written a handful of political risk contracts. Pricing overall has been robust, as have terms and conditions, particularly in the retrocession and direct commercial property classes. Trading conditions in these classes steadily improved through 2006. While demand for our retrocession product may reduce as a result of the Florida State backed reinsurance facility, 2007 trading conditions for retrocession and direct and facultative property are generally expected to remain at levels close to those of 2006. Trading conditions in terrorism, although softening, remain reasonably good on a risk-adjusted basis.

ENERGY

The energy segment includes offshore and onshore energy written on a worldwide basis. The Gulf of Mexico offshore energy class represented approximately 68% of energy premium written through December 31, 2006. Trading conditions in this class have been unprecedented. Pricing was consistently up several hundred percent from 2005, accompanied by dramatic tightening in terms and conditions. Trading conditions elsewhere in the world also improved markedly over 2005, albeit not to the extreme extent seen in the U.S. Looking ahead, while the majority of energy renewals take place in the second quarter, we currently see little change in supply or demand for Gulf of Mexico wind exposed deals. Pricing is expected to decrease only marginally, remaining at excellent levels. Outside the Gulf of Mexico, we continue to expand our book, with further opportunities expected to arise following the establishment of our Middle East marketing presence.

We must maintain a strong balance sheet at all times.

We don't have a strategic target level of capital.

MARINE

This segment includes marine excess of loss and a number of marine hull, marine war, marine P&I and other miscellaneous marine classes. As reported in earlier trading statements, marine excess of loss renewal prices were disappointing in 2006 and conditions meant that marine represented a smaller proportion of our overall book than initially anticipated. However, with the addition of a marine team in mid-2006, we were able to gradually build a good quality book. While conditions in general remain depressed for 2007, by entering the year with a full team we are in a good position to trade carefully but successfully in this segment.

AVIATION

To date, our aviation focus has been centered on AV52 war carve-out business. We do not write general aviation business at this time, as we believe pricing is inadequate. AV52 pricing has been excellent on a risk adjusted basis although we predict some softening during 2007. We may also write a small number of aviation industry loss warranty contracts and satellite programs.

OUTWARDS REINSURANCE

Outwards reinsurance premiums ceded in the twelve month period were $78.5 million, including $29.9 million of Gulf of Mexico offshore energy premiums ceded to Sirocco Reinsurance Limited, a Bermuda reinsurer in which Lancashire invested $20.0 million in June 2006. We expect that the ratio of ceded premiums to gross written premiums will remain relatively similar in 2007 compared to 2006.

Net premiums earned were $243.5 million for the year. As a newly formed group of companies with no existing book of unearned policies, there was a substantial difference between the relative size of premiums written and premiums earned because policies written generally earn over a twelve month period. Gross premiums earned as a proportion of gross premiums written was a modest 48.4% in 2006, but this ratio will increase substantially in 2007.

The loss ratio for the twelve months to December 31, 2006 was 16.1%, driven by the relative absence of large loss events in the major classes written by Lancashire. All but a de minimis amount of the loss expense recorded is in respect of losses incurred but not reported. We do not expect the unusual loss conditions of 2006 to be repeated in 2007.

The acquisition cost ratio for the period was 14.3% and the underwriting operating expense ratio was 13.9%. The acquisition cost ratio is expected to increase only marginally in 2007. The underwriting operating expense ratio for 2006 is significantly higher than the expected long term ratio due to the lag in net premiums earned in the first year of operations. In 2007, the operating expense ratio should be well below 10%.

Net investment income for 2006 was $56.0 million. The fixed income portfolio is currently yielding 5.3%. During the year, we realised $0.8 million of net gains, and generated an unrealised gain of $8.7 million. The split of assets at December 31, 2006 was fixed income 65%, cash 29% and equities 6%. The weighted average duration and credit quality of our fixed income portfolio was 2.3 years and AA+, respectively.

Employee warrants and option expense is the accrual of the fair value of warrants and options granted to employees. The fair value is calculated on the grant date and will be expensed over the vesting period of each security, which is between three and four years. The fair value is expensed in the income statement and there is a corresponding credit to share premium in the balance sheet resulting in a net zero impact on total shareholders' equity. The warrants were a one-off creation at the time of the IPO in late 2005. Due to their non-recurring nature, they are not included in operating income as defined. Options are a recurring expense and are included within operating income.

Total capital at December 31, 2006 was $1.3 billion, comprising $1,137.6 million of common equity and $128.6 million of long term debt. Leverage is 10.2%. Fully converted book value per share at December 31, 2006 was $5.68 compared to $4.84 at December 31, 2005, representing growth of 17.4% in the twelve months to December 31, 2006. Based on projected opportunities for 2007, we believe the level and mix of capital is appropriate. This will be reassessed by management as the trading environment evolves.

NEIL MCCONACHIE, CHIEF FINANCIAL OFFICER

Non-Executive Directors

ROBERT SPASS (age 51)
Non-Executive Chairman
Robert Spass is the Chairman of the Board and a partner and co-founder of Capital Z, a private equity fund specialising in the financial services industry. Mr Spass is also the Chairman of the Board and a partner and co-founder of Union Square Partners Management, LLC, the successor firm to Capital Z. Prior to founding Capital Z, Robert Spass was the Managing Partner and co-founder of Insurance Partners, L.P. from 1994 to 1998 and was President and CEO of International Insurance Advisors L.P. from 1990 to 1994. Both Insurance Partners L.P. and International Insurance Advisors L.P. were private equity funds focused on investments in the global insurance and reinsurance industries. Robert Spass currently serves on the Board of directors of Universal American Financial Corp., Endurance Specialty Holdings, Ltd., USI Holdings Corporation and other privately held companies.

RALF OELSSNER (age 62)
Non-Executive Director
Ralf Oelssner is Vice President, Corporate Insurance for Lufthansa German Airlines. In 1979, he became Director, Corporate Insurance, and in 1990 was appointed Managing Director of Lufthansa's in-house broker. Ralf Oelssner became a member of the Executive Board of the captive insurance and reinsurance companies of Lufthansa in 2000. Ralf Oelssner served as Chairman of the International Air Transport Association ("IATA") in 1982 and 1983 and as Chairman of the IATA Risk & Insurance Managers' Panel in 2001 and 2002. He is currently Chairman and President of Airline Mutual Insurance, Bermuda and President of the German Risk Managers' Association. He holds an M.A. in Economics from Cologne University.

WILLIAM SPIEGEL (age 44)
Non-Executive Director
William Spiegel is a founder of Pine Brook Partners, a private equity firm that focuses on investments in the financial services and energy areas. William Spiegel has over 16 years of private equity experience including more than six years of financial services investment experience. He was with the Cypress Group from inception in 1994 until 2006, where from 2005 he served as that firm's President. Beginning in 2001, William Spiegel managed the financial services and healthcare investing activities of Cypress and served as a Director of all of Cypress' financial services and healthcare portfolio companies: Catlin Group Limited, FGIC Corporation, MedPointe, Inc., Montpelier Re Holdings Ltd. and Scottish Re Group Limited. Prior to joining Cypress, William Spiegel worked in the Merchant Banking Group at Lehman Brothers. He has served on the Boards of four public companies and two private companies. William Spiegel holds a B.Sc. in Economics from the London School of Economics, an M.A. in Economics from the University of Western Ontario and an M.B.A. from the University of Chicago.

MARTIN THOMAS (age 43)
Non-Executive Director
Martin Thomas has spent his career as a solicitor and was most recently an official of the Bank of England on secondment to the EU Commission. At the Commission, he worked

in the Financial Services Policy and Financial Markets Directorate of the EU Commission's Internal Market and Services Directorate General. Before Martin Thomas joined the Commission, he established the Financial Markets Law Committee at the Bank of England. Prior to that he was Deputy Chief Executive of the Financial Law Panel and Senior Counsel to the European Central Bank in Frankfurt. He started his career in private practice, specialising in corporate and commercial litigation at Travers Smith, and the law and regulation of financial services at Clifford Chance.

BARRY VOLPERT (age 47)
Non-Executive Director
Barry Volpert is co-founder, Chairman and Chief Executive Officer of Crestview Partners, L.P. a private equity firm. Prior to founding Crestview Partners, L.P. he was a partner at Goldman, Sachs & Co., where he was most recently head of the Merchant Banking Division in Europe, co-Chief Operating Officer of the Principal Investment Area worldwide and a Director of Goldman Sachs International. He has a J.D. and M.B.A. from Harvard and received an A.B. from Amherst College. He has served on the Boards of many public and private companies.

Executive Directors

RICHARD BRINDLE (age 44)
Chief Executive Officer
Prior to setting up Lancashire in October 2005, Richard Brindle was a non-executive member of the Board of Ascot Underwriting Agency from 2001, which position he held until his resignation in September 2005. As part of his directorship duties at Ascot, Richard Brindle was responsible for independent underwriting review and was chair of the strategic business development committee. He started his career in 1984 working at Posgate and Denby Managing Agency which was later taken over by Charman Underwriting Agencies. In 1989 Richard Brindle was appointed as Deputy Underwriter of Syndicate 488. In 1991 he was appointed as a Director of Charman Underwriting Agencies and acted as main underwriter until 1999. Richard Brindle left Charman Underwriting Agencies when it was sold to ACE in Bermuda.

NEIL MCCONACHIE (age 34)
Chief Financial Officer
Before joining Lancashire in February 2006 Neil McConachie was Senior Vice President, Treasurer and Chief Accounting Officer of Montpelier. Mr McConachie joined Montpelier at its inception and his role included setting up accounting processes, control systems and arrangements with outsourcers. He was extensively involved in debt and equity capital markets transactions, including the initial public offering of Montpelier in October 2002, and was responsible for Montpelier's treasury and accounting functions as well as the control functions and outsourcing arrangements. Prior to joining Montpelier, Mr McConachie was employed by PricewaterhouseCoopers in London and Bermuda and at Stockton Reinsurance Limited, a non traditional reinsurer based in Bermuda. Mr McConachie holds a B.A. in Accounting and Finance from Heriot-Watt University, an M.B.A. with Distinction from Heriot-Watt University and is a member of the Institute of Chartered Accountants of Scotland.

Company Secretary

GREG LUNN
General Counsel and Company Secretary
Before joining Lancashire in 2006, Greg Lunn spent almost 9 years with the ACE Group of Companies, most recently at ACE Limited in Bermuda where he was Compliance Counsel. Between 2000 and 2003 Greg was Legal Counsel for ACE European Group in London. His responsibilities included the reviewing of legal service requirements for ACE Europe and provisions of European and English law legal advice on a wide range of strategic and transactional issues affecting the ACE European Group, including the implementation of the UK Financial Services and Markets Act 2000.

Senior Management – Bermuda Operations

SIMON BURTON
Deputy Chief Underwriting Officer and Chief Operating Officer
Simon Burton joined Lancashire in March 2006 after 10 years at Financial Solutions International (FSI), an underwriting division of the ACE Group of Companies that specialises in non-traditional products including insurance, reinsurance, retrocessional and retrospective risks. He held various roles within FSI, his most recent being President of the unit with full responsibility for underwriting, operations and financial performance of FSI offices in Bermuda, London, Dublin and Sydney. Prior to joining ACE, Simon Burton was a consulting actuary at Tillinghast-Towers Perrin in London and Bermuda.

CHARLES MATHIAS
Underwriting Manager
Charles Mathias is an insurance executive with 22 years experience in the insurance industry spanning broking, underwriting and management. He has experience of working in London, Latin America and the US and has previously established and managed broking and underwriting entities. Prior to joining the Company, Charles Mathias worked at the Lloyd's broker RK Harrison Limited since 2003. Before that he was employed by Seascope Insurance Services Limited, another Lloyd's broker where he was responsible for a non-marine portfolio. He has also founded two Texas underwriting managers; RISC International LLC, a US underwriting manager where from 1995 to 1999 he was President and was responsible for all aspects of company formation and policy and IRM, Inc., where he was Senior Vice President from 1991 to 1995.

SYLVAIN PERRIER
Chief Actuary
Sylvain Perrier spent the last four years prior to joining Lancashire as an actuary at Arch Re, where he reported to the Chief Actuary and CEO in Bermuda. His assignments at Arch Re included reserving, pricing and portfolio risk analysis. He was also responsible for implementation of controls surrounding the actuarial function including compliance with Sarbanes-Oxley. Before joining Arch Re, Sylvain Perrier worked for eight years as an actuarial consultant for Tillinghast-Towers Perrin on various assignments including pricing and rate filings, reserving and Dynamic Financial Analysis.

Senior Management – London Operations

PAULA PORTER

Director, Lancashire Insurance Marketing Services Limited and Chief Executive Officer, Lancashire Insurance Company (UK) Limited

Before joining the Lancashire Group, Paula Porter previously worked for Houston Casualty Company in London from October 1999 as Senior Property Underwriter for the start-up London office of that company. While there, she was responsible for underwriting a US (70%) and International (30%) open market book, primarily for Fortune 500 companies. From January 1986 to October 1999, Paula Porter worked for Sedgwick Insurance Brokers (latterly Marsh Inc) in London. Her final position at Sedgwick/Marsh, following a major re-organisation, was as Managing Director of the client team for Power, Nuclear, Utilities, Construction and Mining, Worldwide, being responsible for a team of 50 people in London.

ALEX MALONEY

Director – Lancashire Insurance Marketing Services Limited and Lancashire Insurance Company (UK) Limited

Alex Maloney spent 14 years with Zurich Financial Services and, before joining the Lancashire Group, managed the London Exploration and Production division of Zurich Global Energy. During his underwriting career he built expertise in the key energy classes. His team at Zurich wrote insurance for independent oil and gas companies and national oil companies. Alex Maloney has experience of underwriting in a variety of jurisdictions. He assisted in establishing Zurich Global Energy's presence in the Bermuda Insurance market, spent two years in Zurich's New York office and has significant experience in the London market.

Robert Spass	(Non-Executive Chairman)
Ralf Oelssner	(Non-Executive Director)
William Spiegel	(Non-Executive Director)
Martin Thomas	(Non-Executive Director)
Barry Volpert	(Non-Executive Director)
Richard Brindle	(Chief Executive Officer)
Neil McConachie	(Chief Financial Officer)

Address	Mintflower Place, 8 Par-la-Ville Road, Hamilton HM 08 Bermuda
Registered Office	Clarendon House, 2 Church Street, Hamilton HM 11 Bermuda
Company Secretary	Greg Lunn
Principal Bankers	The Bank of Bermuda, 6 Front Street, Hamilton HM 11 Bermuda
Registrar	Capita IRG (Offshore) Limited, Victoria Chambers, Liberation Square, 1/3 The Esplanade, St Helier Jersey
Depositary	Capita IRG Trustees Limited, The Registry, 34 Beckenham Road, Beckenham, Kent BR3 4TU England
Legal Counsel (Bermuda)	Conyers Dill & Pearman, Clarendon House, 2 Church Street, Hamilton HM 11 Bermuda
Legal Counsel (UK and US)	LeBoeuf Lamb Greene & MacRae, No. 1 Minster Court, London EC3R 7YL England
Auditors	Ernst & Young, Reid Hall, 3 Reid Street, Hamilton HM 11 Bermuda
Internal Auditors	PricewaterhouseCoopers, Dorchester House, 7 Church Street Hamilton HM 11 Bermuda

Directors' report

STATUS OF THE COMPANY

Lancashire is a Bermuda incorporated company with operating subsidiaries in Bermuda, London and Dubai. The Company was admitted to AIM in December 2005.

PRINCIPAL ACTIVITIES AND REVIEW OF BUSINESS

The Company's principal activity, through its wholly owned subsidiaries, is the provision of global property insurance and reinsurance products. Further discussion of the Company's principal activities and business during 2006 is contained in the Chairman's, CEO's and CFO's statements.

DIVIDENDS

At this time, given current underwriting opportunities, the Directors are not recommending that a dividend is paid for the 2006 financial year.

DIRECTORS

The names and dates of appointment of the Directors who served during 2006 are set out in the Corporate Governance section of this report. Biographical information for all the Directors is included in the description of The Team earlier in this annual report.

DIRECTORS' INTERESTS

The Directors' beneficial interests in the Company's common shares as at December 31, 2005 and December 31, 2006 including interests held by family members were as follows:

Director	Common shares held at December 31, 2005	Common shares held at December 31, 2006
Robert Spass	–	272,500
Ralf Oelssner	–	–
William Spiegel	63,240	63,240
Martin Thomas	–	–
Barry Volpert	–	–
Richard Brindle	300,000	300,000
Neil McConachie	20,000	20,000

Richard Brindle holds 46,260 warrants and William Spiegel holds 481,182 warrants over the Company's shares which were awarded prior to the Company's admission to AIM along with other warrants awarded to the Company's founders. In addition to the Directors' interests set out above, Barry Volpert is managing member, Chairman and CEO of Crestview LLC which is interested in 15,000,000 shares in the Company and 1,183,180 warrants over the Company's shares. Robert Spass is the beneficial owner of 1,549,135 warrants over the Company's shares.

Richard Brindle and Neil McConachie, the Company's executive Directors also hold share options and management warrants as part of their remuneration packages. Further details are included in the Directors' Remuneration Report.

TRANSACTIONS IN OWN SHARES

The Company repurchased 83,775 of its common shares with a nominal value of US$0.50 in accordance with the cashless exercise procedure of certain warrants issued prior to the Company's admission to AIM. 113,219 warrants were exercised on December 28, 2006 and 83,775 shares were repurchased effective as of that date for an aggregate deemed consideration of $566,095 based on market value and in accordance with the terms of the warrants. The repurchased shares were cancelled as at December 28, 2006.

DIRECTORS' REMUNERATION

Details of the Directors' remuneration are set out in the Directors' Remuneration Report.

SUBSTANTIAL SHAREHOLDERS

As at March 1, 2007 the Company was aware of the following interests of 3% or more in the Company's issued share capital:

Name	Number of shares as at March 1, 2007	% of shares in issue
SAB Capital Management, L.P.	6,019,159	3.1
Caisse de dépôt et placement du Québec	22,619,350	11.6
Crestview Partners LLP	15,000,000	7.7
Och-Ziff Capital Management	18,336,176	9.4

CORPORATE GOVERNANCE

The Company's compliance with the Combined Code on Corporate Governance 2006 is set out in the Corporate Governance section of this report.

POLITICAL AND CHARITABLE DONATIONS

The Group did not make any significant charitable donations during 2006. However, the Group intends to make more substantial charitable donations in 2007. The Board has approved the establishment of the Lancashire Foundation, a charitable trust, to benefit charitable causes in Bermuda focusing on special needs and education. Charitable donations may also be made by the Group in the United Kingdom. The Group did not make any political donations or incur any political expenditure during 2006.

HEALTH AND SAFETY

The Group considers the health and safety of its employees to be a management responsibility equal to that of any other function. The Group operates in compliance with health and safety legislative requirements in Bermuda and the UK.

EMPLOYEES

The Group believes that its employees are its most important asset. Lancashire to be an equal opportunity employer, and does not tolerate discrimination of any kind in any aspect of employment, including retirement, recruitment, training, promotion, compensation, benefits, advancement and career development. The Group believes that education and training for employees is a continuous process and employees are encouraged to discuss training needs with their managers. The Group's health and safety, equal opportunities, training and other policies are available to all employees in the staff handbook which is on the Group's intranet.

ENVIRONMENT

Operationally the Group has a relatively small environmental footprint. A particular area in which the Group can address its environmental impact is its corporate travel, and the Group's UK operating company has entered into an agreement to offset its carbon dioxide emissions from flights made by staff for business travel.

CREDITOR PAYMENT POLICY

The Company aims to pay all creditors promptly and in accordance with contractual and legal obligations.

POST BALANCE SHEET EVENTS

On February 25, 2007 Lancashire received notification from the Dubai Financial Services Authority that its application to operate an authorised insurance intermediation firm in Dubai had been approved in principle. The authorisation will be exercised via a wholly-owned subsidiary incorporated and operating within the Dubai International Financial Centre. The new subsidiary, called Lancashire Marketing Services (Middle East) Limited, will allow the Group to market its UK and Bermuda based insurance subsidiaries more effectively and efficiently in the region.

FINANCIAL INSTRUMENTS AND RISK EXPOSURES

Information regarding the Group's risk exposure is included in the risk disclosures in the consolidated financial statements. The Group's use of derivative financial instruments can be found at note 20 of the consolidated financial statements.

ACCOUNTING STANDARDS

The Group's consolidated financial statements are prepared in accordance with International Financial Reporting Standards ("IFRS") endorsed by the European Commission. Where IFRS is silent, as it is in respect of the measurement of insurance products, the IFRS framework allows reference to another comprehensive body of accounting principles. In such instances, management determines appropriate measurement bases, to provide the most useful information to users of the consolidated financial statements, using their judgment and considering the accounting principles generally accepted in the United States ("US GAAP").

AGM

The Company's annual general meeting is scheduled for 1.00pm on May 1, 2007 at the Company's offices, Mintflower Place, 8 Par-la-Ville Road, Hamilton HM 08, Bermuda. Notice of the annual general meeting and the form of proxy accompanies this annual report.

GOING CONCERN

The Board is satisfied that the Company has adequate resources to continue in operation for the foreseeable future. The Company's consolidated financial statements therefore continue to be prepared on a going concern basis.

AUDITORS

Resolutions will be proposed at the Company's annual general meeting to re-appoint Ernst & Young as the Company's auditors and to authorise the Directors to set the auditors' remuneration. Ernst & Young have served as the Company's auditors since 2005.

Approved by the Board of Directors and signed on behalf of the Board.

GREG LUNN, COMPANY SECRETARY, MARCH 7, 2007

COMPLIANCE WITH COMBINED CODE

Lancashire, as an AIM company, is not required to comply with the Combined Code on Corporate Governance published in July 2003 and revised in 2006 ("Combined Code"), however, it intends to comply with the Combined Code to the appropriate extent, taking into account the Company's size and the nature of its business, as soon as is practicable. Currently, the Company complies with the Combined Code except as stated in this Corporate Governance section and in the Directors' Remuneration Report section of this annual report. There are no Bermudian corporate governance standards similar to the Combined Code that apply to Lancashire.

DIRECTORS

As at December 31, 2006 the Directors of the Company and their dates of appointment were as follows:

Director	Position	Date of appointment
Robert Spass	Non-executive Chairman	December 16, 2005
Ralf Oelssner	Non-executive Director	December 9, 2005
William Spiegel	Non-executive Director	December 16, 2005
Martin Thomas	Non-executive Director	September 15, 2006
Barry Volpert	Non-executive Director	December 16, 2005
Richard Brindle	Chief Executive Officer	October 13, 2005
Neil McConachie	Chief Financial Officer	December 9, 2005

Colin Alexander (non-executive Director) resigned from the Board with effect from June 2006 concurrent with his engagement as a full-time employee of the Company.

The Company has not yet appointed a Senior Independent Director but intends to review this in 2007.

In accordance with the Company's bye-laws, the Directors are divided into class I, II and III Directors who hold office until the 2009, 2008 and 2007 annual general meetings respectively. At these meetings the relevant Directors may be re-elected by the Company's shareholders for further three year terms. The class III Directors, Neil McConachie and Martin Thomas, will accordingly be submitting themselves for re-election by the Company's shareholders at the annual general meeting scheduled to take place on May 1, 2007 as detailed in the notice of annual general meeting accompanying this report.

INDEPENDENCE

The Board considers Martin Thomas and Ralf Oelssner to be independent as each is independent in character and judgment and has no relationship or circumstance likely to affect his judgment. As disclosed at the time of the Company's admission to AIM, Robert Spass and Barry Volpert are not considered to be independent under the Combined Code due to their appointment by and affiliation

with specific shareholders. William Spiegel was originally appointed by a founder shareholder of the Company, however he no longer has any shareholder affiliation and the Board considers him to have been independent from the second half of 2006.

The Board is aware that its composition does not currently comply with the Combined Code requirements that independent non-executive Directors should make up at least half of the Board and that the Chairman should be considered independent on appointment. However, the Board considers that its present composition is appropriate for the current stage of the Company's development. The Board and the nomination committee intend to review the composition of the Board and consider any need for additional Directors during 2007.

BOARD

The Board has overall responsibility for the leadership and control of Lancashire's business. The Board has reserved a number of matters for its decision including responsibility for the overall management of the Group and approval of the Group's long term objectives and commercial strategy. The Board has delegated certain matters to the committees described below. The committees report to the Board.

The Board has separate appointments for the roles of Chairman and Chief Executive Officer and has adopted a formal division of responsibilities for these positions during 2007. The day to day management of the Company and implementation of Board decisions and strategy is carried out by the executive Directors and senior management. The Board of Directors generally meets on a quarterly basis. At these meetings, the Board reviews all areas and developments in the Group's business and receives reports from management on finance, underwriting and any other key matters affecting the Company. The Board is regularly provided with information necessary for it to fulfill its responsibilities including quarterly reports and full Board papers. Additional information is provided to the Board as and when necessary and the Directors have access to independent professional advice as required.

The Directors' attendance at the Board meetings held in 2006 was as follows:

Director	Meetings held while a Director	Meetings attended while a Director
Robert Spass	4	3
Ralf Oelssner	4	4
William Spiegel	4	4
Martin Thomas	1	1
Barry Volpert	4	4
Richard Brindle	4	4
Neil McConachie	4	4

The Chairman's other significant commitments are periodically considered by the Board. The Chairman is currently a partner and director of Capital Z Management LLC and its affiliates and also serves on the Boards of Universal American Financial Corp., Endurance Specialty Holdings, Ltd. and USI Holdings Corporation. The Board periodically reviews changes to the Chairman's and other Directors' time commitments.

INFORMATION AND TRAINING

On appointment the Directors receive written information regarding their responsibilities as Directors. Information regarding the Company's AIM and Bermuda law obligations and on the Combined Code is also provided. All the Directors have access to the Company Secretary who is responsible for updating the Board with any legal, regulatory or compliance developments affecting the Company. The Directors also have access to independent legal advice as required.

As all the Directors, except for Martin Thomas, were appointed prior to the Company's admission to AIM when the Company was starting up, a formal induction procedure has not yet been put in place. The Board is currently reviewing the induction process which includes meeting with senior management, visiting the Company's operations and the provision of key information. The Board intends to formalise the induction procedure for subsequent Board appointments.

BOARD PERFORMANCE EVALUATION

As the Company has now been operating for one complete year, the Board considers it appropriate to put in place a performance evaluation procedure. The first performance evaluations are intended to be carried out in the second half of 2007 and to be reported on in the next annual report. The Board as a whole, the committees and the individual Directors will each be evaluated.

RELATIONS WITH SHAREHOLDERS

Throughout 2006, management talked with several of the Company's major shareholders and met with the investor community. Feedback from analysts following presentations was reported to the Board in 2006. Conference calls have been held following announcement of the Company's financial results. The Company has also commissioned shareholder reports to review the make up of its beneficial shareholder base. The Company's Chairman and the non-executive Directors are also available to meet with major shareholders at the Company's annual general meeting and throughout the year. Shareholders are encouraged to attend the Company's annual general meeting and to vote on shareholder resolutions. Leading up to the 2006 annual general meeting the Company contacted several major shareholders to encourage proxy returns.

COMMITTEES

The Board has established nomination, audit, remuneration, investment and underwriting committees. The committees' responsibilities are contained in their terms of reference and their reporting obligations are to the Board. The committees are generally scheduled to meet quarterly prior to the Board meetings at which they report. The composition of the committees as at December 31, 2006 was as follows:

Director	Nomination	Audit	Remuneration	Investment	Underwriting
Robert Spass	Yes (Chair)	Yes (Chair)			
Ralf Oelssner		Yes	Yes		Yes
William Spiegel		Yes	Yes (Chair)	Yes (Chair)	
Martin Thomas	Yes	Yes	Yes		Yes
Barry Volpert	Yes			Yes	
Richard Brindle	Yes				Yes (Chair)
Neil McConachie				Yes	

NOMINATION COMMITTEE

The members of the nomination committee at the start of 2006 were Robert Spass (Chair), Richard Brindle and William Spiegel. Barry Volpert was appointed to the Committee and William Spiegel stepped down in March 2006. Martin Thomas was appointed as an additional committee member in November 2006. The composition of the committee currently does not conform to the Combined Code requirement that a majority of the nomination committee should be independent non-executive Directors. However the Board considers that the current composition is appropriate for the Company's first year of operations. The Board intends to review the nomination committee membership in 2007. The nomination committee met four times during 2006. Robert Spass missed one meeting held while he was a member. The other members attended all meetings held in 2006 while they were on the nomination committee.

The nomination committee's responsibilities are contained in its terms of reference. These include reviewing the structure, size and composition (including the skills, knowledge and experience) of the Board and making recommendations regarding changes. In 2006 the nomination committee recommended the appointment of Martin Thomas to the Board as an additional independent non-executive Director and his further appointments to the nomination, audit, remuneration and underwriting committees. The Company did not use an external search agency or open advertising for Mr Thomas's appointment but will review its recruitment processes as it considers appropriate during 2007.

AUDIT COMMITTEE

The members of the audit committee during 2006 were Robert Spass (Chair), Ralf Oelssner and William Spiegel. Martin Thomas was appointed as an additional committee member in November 2006. The Board considers that Robert Spass has recent and relevant financial experience. The composition of the

audit committee was not in conformity with the Combined Code during 2006 as the Company's Chairman was a member and it did not consist of a majority of independent non-executive Directors. The nomination committee and the Board intend to review the membership of all the committees in 2007. The audit committee met four times during 2006. Robert Spass attended three meetings and the other audit committee members attended all the meetings held during 2006 while they were members.

The audit committee is responsible for the effectiveness of the internal and external audit functions. The audit committee's responsibilities are contained in its terms of reference. These include reviewing and reporting to the Board on the preparation of the Company's financial information, announcements relating to the Company's financial results and monitoring the independence of the Company's auditors. Key work carried out by the audit committee during 2006 is detailed in the Internal Controls section of this report.

REMUNERATION COMMITTEE

The members of the remuneration committee at the start of 2006 were William Spiegel (Chair), Ralf Oelssner and Colin Alexander. Colin Alexander stepped down from the remuneration committee on his resignation as a Director in June 2006. Martin Thomas was appointed in November 2006. The remuneration committee met three times in 2006 and the members attended all the meetings held while they were members.

The remuneration committee's responsibilities are contained in its terms of reference. These include determining remuneration for the Company's executives and senior management of the Group within a framework agreed with the Board. During 2006 the remuneration committee considered and approved the grant of management warrants and awards of options under the Company's long term incentive plan and recommended that the Company's long term incentive plan be clarified to allow for cashless exercise, which was approved by the Board in November 2006. A full report of the Directors' remuneration is included in this annual report.

INVESTMENT COMMITTEE

The members of the investment committee at the start of 2006 were William Spiegel (Chair), Neil McConachie and Colin Alexander. Colin Alexander stepped down from the investment committee on his resignation as a Director in June 2006. Barry Volpert was appointed in March 2006. The investment committee's responsibilities are contained in its terms of reference. These include recommending and monitoring investment strategies, recommending appointments of fund managers for the Group's investments and monitoring the cash flow, liquidity and working capital of the Group. During 2006, the investment committee recommended investment guidelines for adoption by the Board, recommended the appointment of investment managers for the Group's fixed income and equity investments, and monitored the Group's investment performance. The investment committee met four times in 2006 and the members attended all the meetings held while they were members.

UNDERWRITING COMMITTEE

The members of the underwriting committee at the start of 2006 were Richard Brindle (Chair) and representatives of the Company's underwriting team. Ralf Oelssner was appointed as an additional Director member in March 2006. The underwriting committee's responsibilities are contained in its terms of reference. These include reviewing and monitoring compliance with the Group's underwriting guidelines and policies, formulating underwriting strategy, reviewing aggregate underwriting exposures and reviewing compliance with Probable Maximum Losses ("PML"). During 2006 the underwriting committee recommended underwriting guidelines for the Group and reviewed the Group's underwriting activities in light of the Group's overall strategy and business plan. The underwriting committee met four times in 2006 and the members attended all the meetings held while they were members.

INTERNAL CONTROLS

The Board is responsible for maintaining a sound system of internal control and risk management and for reviewing the effectiveness of the Group's risk and control processes. The Board has delegated responsibility to the audit committee for reviewing the Group's internal control and financial reporting systems (including financial, operational, compliance and risk management). These systems are intended to identify significant risks facing the Company so such risks can be appropriately managed and where appropriate reduced. The Board acknowledges that the Company cannot eliminate risk but believes that a comprehensive assessment of the risks facing the Company helps to operate the business within acceptable levels of risk. The audit committee reports to and makes recommendations to the Board regarding the effectiveness of the internal controls and risk management. During 2006 the audit committee reviewed the effectiveness of the Company's internal controls and risk management systems, reviewed the Company's financial reporting, held closed sessions respectively with the Company's auditors and with management, recommended that PricewaterhouseCoopers ("PwC") be retained to carry out internal audits and risk assessments and recommended the adoption of a whistle-blower policy that has been approved by the Board.

INTERNAL AUDIT AND RISK ASSESSMENTS

In 2006, on the recommendation of the audit committee, the Company engaged PwC to carry out internal audits and to report on the Company's internal controls and processes in respect of aggregation of risk, IT governance and compliance with underwriting policies and procedures. In addition, in early 2006 a comprehensive risk assessment was carried out by management with PwC's assistance. This risk assessment was updated at the end of 2006 and in early 2007. The findings of the internal audits and risk assessments have been reviewed by the audit committee and the Board, and the Company is implementing the recommendations made by PwC. The audit committee also held closed sessions with PwC in relation to their internal audit work.

EXTERNAL AUDIT AND PROVISION OF NON AUDIT SERVICES

The audit committee is responsible for reviewing and monitoring the external auditors' objectivity and reporting to the Board to ensure that the auditors' objectivity and independence is safeguarded. The Board is responsible for reviewing the effectiveness of the external audit which is reported on by the audit committee. Due to the start-up nature of the Company, during 2006 Ernst & Young performed certain non audit services relating to the commencement of the Company's business and provided similar start-up advice and services in relation to the commencement of the Group's UK underwriting operations. During 2006, the audit committee monitored the provision of these services which have now been reduced. The audit committee and the Board are currently satisfied with the objectivity and independence of the auditors.

ENTERPRISE RISK MANAGEMENT

Lancashire has adopted an enterprise risk management culture within its operations and systems. During 2006 it retained PwC to review the Group's risk management processes and to make recommendations to progress the Company's enterprise risk management development. The Group has implemented the following key risk management processes and strategies during 2006 and will continue to focus on enterprise risk management during 2007:

- established underwriting line and limit authorities, by underwriter and line of business
- adopted a conservative capital management/underwriting strategy which includes specific aggregation and correlation limits and a PML target of less than 25 per cent of total capital in attempts to monitor and mitigate the Group's overall exposure to major loss events
- approved an investment strategy and communicated this to the Group's investment managers
- conducted a Group-wide risk assessment in early 2006 and updated this at the end of 2006 and in early 2007
- ensured that key processes, departmental risks and controls are documented throughout the organisation
- documented policies and guidelines including underwriting guidelines, operating guidelines, accounting policy and procedures, HR policies and procedures
- established a risk committee in the Group's Bermuda and UK operations
- performed internal audit reviews over key risk areas and performed quarterly reporting to the audit committee based on findings
- established a compliance team that will undertake compliance testing activities
- began developing an in-house tool to document, maintain and track risk management efforts.

DIRECTORS' REMUNERATION REPORT

Because Lancashire is an AIM listed company, the Directors' Remuneration Report Regulations 2002 do not apply to Lancashire. However, the Board is committed to providing information to shareholders and complying with corporate governance standards and best practices to the appropriate extent, taking into account the Company's size and the nature of its business.

REMUNERATION COMMITTEE

Details of the remuneration committee members and its terms of reference are set out in the corporate governance section of this annual report.

REMUNERATION OF NON-EXECUTIVE DIRECTORS

The non-executive Directors serve under letters of appointment. They receive an annual fee of $85,000 for their Board appointment, $15,000 for chairmanship of the audit committee, $5,000 for chairmanship of the remuneration and investment committees and $2,000 for each Board or committee meeting attended. Robert Spass receives an additional $15,000 for his role as Chairman of the Board.

In addition to the above fees, Ralf Oelssner receives $30,000 per annum for his appointment as a non-executive Director of the Company's UK subsidiary Lancashire Insurance Company (UK) Limited and Martin Thomas receives $50,000 per annum for his appointment as non-executive Chairman of Lancashire Insurance Company (UK) Limited. Martin Thomas and Ralf Oelssner receive $2,000 for each Lancashire Insurance Company (UK) Limited Board or committee meeting that they attend and Martin Thomas also receives $5,000 per annum for each of his chairmanships of the risk committee and audit committee of that company. The non-executive Directors receive no other remuneration. Their terms of office are set out in the corporate governance section of this annual report and their letters of appointment are available for inspection at annual general meetings. Colin Alexander did not personally receive any fees for his services as a Director for the first half of 2006 as he was employed during his term of office by International Advisory Services Ltd ("IAS") who were retained by the Company to provide general management services. The fees paid to IAS during 2006 are detailed later in this Directors' Remuneration Report.

During 2006 the Company retained PwC to carry out a review of non-executive compensation. A further review has been carried out in 2007, and the Board will consider its recommendations in setting non-executive Director remuneration.

REMUNERATION POLICY

The Company's policy is to create remuneration packages that will enable it to recruit and maintain suitably experienced individuals. The executive and employee remuneration packages should include an appropriate incentive based element as considered reasonable and necessary to drive individual performance and to fairly reward the executive Directors and staff for their contribution to the successful performance of the Company. The Company has retained independent consultants to undertake a review of senior executive compensation.

EXECUTIVE DIRECTORS SERVICE CONTRACTS

The executive Directors' remuneration is made up of the following elements which are set out in detail below:

- base salary
- basic bonus
- additional bonus linked to the Company's performance
- share options
- performance warrants
- time-vesting warrants
- pension
- benefits, including medical, dental, vision coverage, air travel and housing and other allowances for expatriates.

Richard Brindle was appointed as Chief Executive Officer and Chief Underwriting Officer under a service contract dated December 9, 2005. Neil McConachie was appointed as Chief Financial Officer under a service contract dated February 1, 2006. Both Richard Brindle's and Neil McConachie's service contracts are for terms of three years after which they may be extended by agreement. As at December 31, 2006, the unexpired term of both Richard Brindle's and Neil McConachie's service contracts is approximately two years. Both service contracts contain six month notice provisions. Richard Brindle is also employed by the Group's UK operations under a service contract dated December 12, 2005. This service contract is also for a term of three years after which it may be extended by agreement and contains a six

month termination provision. As at December 31, 2006 the unexpired term of this service contract is approximately two years. Details of the salaries payable under these contracts are set out in the emoluments table at the end of this Directors' Remuneration Report.

BASIC BONUS PLAN

The Company operates a basic management bonus plan under which, for 2006, the Company's first year of operations, Richard Brindle and Neil McConachie were entitled to a minimum bonus of 75 per cent of base salary. The maximum bonus payable for 2006 was 250 per cent of base salary for Richard Brindle and 200 per cent of base salary for Neil McConachie. Details of the bonuses awarded to Richard Brindle and Neil McConachie under this plan are set out in the emoluments table at the end of this Directors' Remuneration Report. For subsequent years, there will be no guaranteed minimum bonus under the basic bonus plan but the maximum bonus percentages will apply. In addition, the amounts of annual bonuses in the aggregate under the basic bonus plan and the additional bonus plan which may be paid to any individual are subject to a maximum amount described in relation to the additional bonus plan below. The actual amount of the bonus paid out by the Company to the executive Directors is determined by the remuneration committee (upon the recommendation of the Chief Executive Officer in respect of the Chief Financial Officer) based on individual and corporate performance.

ADDITIONAL BONUS PLAN

In addition to the basic bonus plan, the Company operates an additional bonus plan under which formula-based additional bonuses may be paid to the executive Directors and other eligible employees in addition to the basic bonuses described above. For 2006, the additional bonuses, if any, will be determined following the publication and review of comparator peer group companies in accordance with the plan. The amounts payable under the additional bonus plan are based on a formula which reflects both absolute and relative returns in any one year, with each such performance condition/threshold met contributing 50 per cent of the possible sum paid to the individual. Under the additional bonus plan, one half of the bonus will be payable under an absolute return pool that will comprise 2.5 per cent of the profits generated to the extent the Group's return on equity for that year exceeds the Group's return on equity for that year as projected at the time of the Company's admission to AIM. The other one half of the additional bonus will be payable under a relative return pool that will comprise 2.5 per cent of the profits generated to the extent the Group's return on equity exceeds the average of a peer group of comparable insurance and reinsurance companies. The allocation of any amounts in the pools payable under the additional bonus plan to the Chief Executive Officer is limited to 35 per cent and in addition is subject to the aggregate maximum limits below. The maximum amount payable in the aggregate under the combination of the basic bonus plan and the additional bonus plan shall be 500 per cent of base salary in the case of the Chief Executive Officer, and 400 per cent of base salary for the Chief Financial Officer.

LONG TERM INCENTIVE PLAN

In 2005, the Board adopted a Long Term Incentive Plan ("LTIP") (which has not been submitted for approval by HM Revenue & Customs) to enable any full-time executive Director or employee of the Group (provided that the individual is not within six months of retirement) to be granted share options at the discretion of the remuneration committee. The options are time-vesting and there are no performance conditions to be satisfied before exercise of an option. The options vest as to 25 per cent on the first anniversary, 50 per cent on the second anniversary, 75 per cent on the third anniversary and 100 per cent on the fourth anniversary of the date of grant provided that the option holder remains in the employment of the Group at the relevant anniversary. The exercise price is the average of the middle market quotations for the twenty dealing days preceding the grant but not less than the nominal value of the Company's shares. As disclosed in Lancashire's AIM admission document, the LTIP does not comply with certain provisions of the Combined Code. During 2006 the Board amended the LTIP to allow for cashless exercise by option holders. No options were exercised during 2006. Details of the Directors' share options for 2006 are as follows:

Name of Director	Share options at 31/12/ 2005	Share options at 31/12/ 2006	Date of award	Price paid	Exercise price	Exercise date	Expiry date	Vesting conditions
Richard Brindle	Nil	762,522	9/3/06	Nil	£3.25325	25% on 9/3/07	8/3/16	Time-vesting
Neil McConachie	Nil	508,348	9/3/06	Nil	£3.25325	25% on 9/3/07	8/3/16	Time-vesting

MANAGEMENT WARRANTS

During 2006, the Company granted time-vesting warrants ("Ordinary Warrants") and performance-vesting warrants ("Performance Warrants") to the executive Directors and other employees of the Group.

The Ordinary Warrants vest, 25 per cent on issuance and thereafter 25 per cent on each of the first, second and third anniversaries of the Company's admission to AIM on December 16, 2005 except that the Ordinary Warrants awarded to Richard Brindle will vest immediately on a change of control of the Company or in the event of his dismissal (other than for wilful misconduct) as a Director or employee of any Group company and the Ordinary Warrants awarded to Neil McConachie will vest immediately on his dismissal (other than for wilful misconduct) following a change of control of the Company.

The Performance Warrants vest, 20 per cent on December 31, 2007, 40 per cent on December 31, 2008 and 40 per cent on December 31, 2009 subject to the Company achieving certain performance conditions described in note 6 of the consolidated financial statements included in this report. As disclosed in the Company's AIM admission document, the warrants do not comply with certain provisions of the Combined Code. Details of the Ordinary Warrants and Performance Warrants held by the Directors during 2006 are as follows:

Name of Director	Warrants at 31/12/ 2005	Warrants at 31/12/ 2006	Date of award	Price paid	Exercise price	Expiry date	Vesting conditions
Richard Brindle	7,625,217	7,625,217	December 16, 2005	Nil	$5.00	December 16, 2015	Time vesting
	3,050,087	3,050,087	December 16, 2005	Nil	$5.00	December 16, 2015	Performance conditions as above
Neil McConachie	635,435	1,270,869	635,435 on December 16, 2005 and 635,434 on March 9, 2006	Nil	$5.00	December 16, 2015	Time vesting
	381,261	762,522	381,261 on December 16, 2005 and 381,261 on March 9, 2006	Nil	$5.00	December 16, 2015	Performance conditions as above

PENSIONS

Richard Brindle and Neil McConachie receive pension contributions from the Company under a defined contribution pension plan the Company operates for its employees. Under this plan, and in line with market practice in Bermuda, the Company contributes 10% of base salary up to a maximum of $20,000. In addition Richard Brindle receives contributions to a UK defined contribution pension plan in respect of his salary and employment with the Company's UK operations. Details of their 2006 pension contributions are set out in the emoluments table at the end of this Directors' Remuneration Report.

PAYMENTS TO THIRD PARTIES

On January 1, 2006, three of the Company's founder shareholders, Capital Z Lancashire Partners, L.P., Cypress Lancashire Partners, L.P. and Crestview Advisors, L.L.C., entered into an agreement to provide monitoring services to the Company. Under the agreement, these founder shareholders receive an annual fee for the monitoring services provided they hold a seat on the Company's Board. For monitoring services provided during 2006, Capital Z Lancashire Partners, L.P., received $212,000, Cypress Lancashire Partners, L.P. received $22,750 and Crestview Advisors, L.L.C. received $69,500. From May 2006, Cypress Lancashire Partners, L.P. no longer held a seat on the Company's Board and consequently will no longer provide any monitoring services to the Company under this agreement. While Colin Alexander was a Director, IAS, with whom he was employed, received $466,561 for general management services provided to the Company which, amongst other work, included the provision of Colin Alexander's services as a Director.

DIRECTORS' EMOLUMENTS

The Directors' emoluments for the year ended December 31, 2006 are set out below:

Director	Salary/fees for the Company	Salary/fees for other Group companies	Basic bonus	Pension	Other benefits	Total
Non-executive Directors						
Robert Spass	133,000	–	–	–	–	133,000
Ralf Oelssner	113,000	18,514	–	–	–	131,514
William Spiegel	125,000	–	–	–	–	125,000
Martin Thomas	26,715	31,043	–	–	–	57,758
Barry Volpert	103,000	–	–	–	–	103,000
Executive Directors						
Richard Brindle	675,000	242,117(1)	2,250,000(1)	48,296(1)	151,111(1)	3,366,524(1)
Neil McConachie	275,000(2)	–	575,500(3)	20,000	264,812(4)	1,135,312

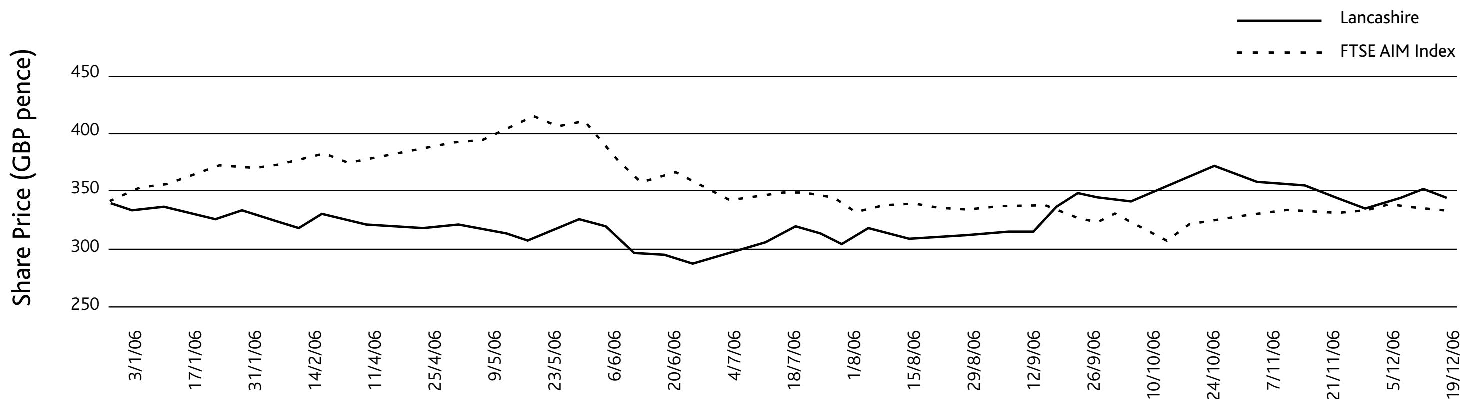
(1) Some amounts paid in pounds sterling and converted at prevailing exchange rates

(2) Full per annum salary for 2006 of $300,000

(3) Includes $50,500 special mid year bonus

(4) Includes $75,000 in lieu of warrants

TOTAL SHAREHOLDER RETURN



The above graph shows the Company's share price performance against the FTSE AIM index (as adjusted to start with a matching 340.50 pence share price for comparison purposes) over the period.

Approved by the Board of Directors and signed on behalf of the Board.

GREG LUNN, COMPANY SECRETARY, MARCH 7, 2007

The Directors are responsible for preparing the Group's consolidated financial statements which give a true and fair view of the state of affairs of the Group and the results of the Group for that period. These are the Group's first full year consolidated financial statements. The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union and where IFRS is silent, as it is in respect of the measurement of insurance products, US generally accepted accounting principles have been used. Further detail on the basis of preparation is described in the consolidated financial statements. In preparing the consolidated financial statements, the Directors are required to:

- select suitable accounting policies and apply them consistently;
- make judgments and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the consolidated financial statements; and
- prepare the consolidated financial statements on the going concern basis unless it is inappropriate to presume that the Company and the Group will continue in business.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company and the Group, for safeguarding the assets of the Group and for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors have elected to include the corporate governance and remuneration information contained in this annual report, although the Company is not required to include these corporate governance and remuneration disclosures.

Legislation in Bermuda governing the preparation and dissemination of the consolidated financial statements may differ from legislation in other jurisdictions. In addition, the rights of shareholders under Bermuda law may differ from those for shareholders of companies incorporated in other jurisdictions.

TO THE SHAREHOLDERS
LANCASHIRE HOLDINGS LIMITED

We have audited the accompanying consolidated financial statements of Lancashire Holdings Limited and its subsidiaries (collectively the "Group"), which comprise the consolidated balance sheet as at December 31, 2006 and the consolidated income statement, consolidated statement of changes in shareholders' equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

MANAGEMENT'S RESPONSIBILITY FOR THE CONSOLIDATED FINANCIAL STATEMENTS

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the European Union. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

AUDITOR'S RESPONSIBILITY

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement.

We read other information contained in the Annual Report and consider whether it is consistent with the audited consolidated financial statements. This other information comprises the Chairman's Statement, CEO's Statement, CFO's letter, Directors' Report, Corporate Governance Statement, Directors' Remuneration Report and Statement of Directors' Responsibilities. We consider the implications of our report if we become aware of any apparent misstatements or material inconsistencies with the consolidated financial statements. Our responsibilities do not extend to any other information.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

OPINION

In our opinion, the consolidated financial statements give a true and fair view of the financial position of the Group as of December 31, 2006, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

/S/ ERNST & YOUNG
March 7, 2007
#3 Reid Street
Hamilton, Bermuda

CONSOLIDATED INCOME STATEMENT

for the year ended December 31, 2006

	Notes	2006 $m	2005 $m
Gross premiums written		626.0	2.6
Outwards reinsurance premiums	25	(78.5)	–
Net premiums written		**547.5**	**2.6**
Change in unearned premiums	13	(323.1)	(2.6)
Change in unearned premiums on premium ceded	13	19.1	–
Net premiums earned		**243.5**	**–**
Net investment income	3	54.2	2.1
Net other investment income	3, 11, 20	1.8	–
Net realised gains (losses) and impairments	3	0.8	–
Share of profit of associate	12	3.2	–
Net foreign exchange gains (losses)		(1.3)	0.3
Total net revenue		**302.2**	**2.4**
Insurance losses and loss adjustment expenses		39.1	–
Insurance losses and loss adjustment expenses recoverable		–	–
Net insurance losses		**39.1**	**–**
Net insurance acquisition expenses	4, 25	34.9	–
Other operating expenses	5, 6, 7	56.4	10.0
Total expenses		**130.4**	**10.0**
Results of operating activities		**171.8**	**(7.6)**
Finance costs	20	12.3	4.0
Profit (loss) before tax		**159.5**	**(11.6)**
Tax	8, 9	0.2	–
Profit (loss) for the period attributable to equity shareholders		**159.3**	**(11.6)**
EARNINGS PER SHARE			
Basic	24	$0.81	$(0.24)
Diluted	24	$0.79	$(0.24)

CONSOLIDATED BALANCE SHEET

as at December 31, 2006

	Notes	2006 $m	2005 $m
ASSETS			
Cash and cash equivalents	10	400.1	1,072.4
Accrued interest receivable	14	7.5	2.0
Investments			
– fixed income securities	11	896.3	–
– equity securities	11	70.3	–
– other investments	11, 20	11.5	–
Reinsurance assets			
– unearned premium on premium ceded	13, 25	19.1	–
Deferred acquisition costs	15	51.5	0.5
Other receivables	14	6.3	0.3
Inwards premium receivable from insureds and cedants	14	173.7	2.1
Deferred tax asset	8, 9	0.8	–
Investment in associate	12	23.2	–
Property, plant and equipment	18	2.4	0.4
Total assets		**1,662.7**	**1,077.7**
LIABILITIES			
Insurance contracts			
– losses and loss adjustment expenses	13	39.1	–
– unearned premiums	13	325.7	2.6
– other payables	13, 16	3.6	–
Amounts payable to reinsurers	13, 16, 25	2.4	–
Deferred acquisition costs ceded	17, 25	2.5	–
Other payables	16	20.8	2.2
Corporation tax payable	9	1.0	–
Interest rate swap	20	0.9	–
Accrued interest payable	19	0.5	0.4
Long term debt	19	128.6	125.4
Total liabilities		**525.1**	**130.6**
SHAREHOLDERS' EQUITY			
Share capital	21	97.9	97.9
Share premium	21, 26	33.6	860.8
Contributed surplus	26	849.7	–
Fair value and other reserves	3, 11	8.7	–
Retained earnings (deficit)		147.7	(11.6)
Total shareholders' equity attributable to equity shareholders		**1,137.6**	**947.1**
Total liabilities and shareholders' equity		**1,662.7**	**1,077.7**

The consolidated financial statements were approved by the Board of Directors on March 7, 2007 and signed on its behalf by:

ROBERT SPASS **NEIL MCCONACHIE**

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
for the year ended December 31, 2006

	Notes	Share capital $m	Share premium $m	Contributed surplus $m	Fair value and other reserves $m	Retained (deficit) earnings $m	Total $m
BALANCE AS AT OCTOBER 12, 2005 (DATE OF INCORPORATION)		**–**	**–**	**–**	**–**	**–**	**–**
Loss for the period		–	–	–	–	(11.6)	(11.6)
TOTAL RECOGNISED LOSS FOR THE PERIOD		**–**	**–**	**–**	**–**	**(11.6)**	**(11.6)**
Issue of share capital	21	97.9	880.7	–	–	–	978.6
Equity offering expenses		–	(58.6)	–	–	–	(58.6)
Formation expenses	26	–	(36.1)	–	–	–	(36.1)
Warrant issues – founders and sponsor	22	–	66.4	–	–	–	66.4
Warrant issues – management	6	–	8.4	–	–	–	8.4
Balance as at December 31, 2005		**97.9**	**860.8**	**–**	**–**	**(11.6)**	**947.1**
Profit for the period		–	–	–	–	159.3	159.3
Change in investment unrealised gains (losses)	3, 11	–	–	–	8.7	–	8.7
TOTAL RECOGNISED INCOME FOR THE PERIOD		**–**	**–**	**–**	**8.7**	**159.3**	**168.0**
Issue of share capital	21	–	0.3	(0.3)	–	–	–
Transfer from share premium to contributed surplus	26	–	(850.0)	850.0	–	–	–
Warrant issues – management and performance	6, 22	–	20.5	–	–	–	20.5
Options issues – management	6, 22	–	2.0	–	–	–	2.0
Balance as at December 31, 2006		**97.9**	**33.6**	**849.7**	**8.7**	**147.7**	**1,137.6**

CONSOLIDATED CASH FLOW STATEMENT

for the year ended December 31, 2006

	Notes	2006 $m	2005 $m
CASH FLOWS FROM OPERATING ACTIVITIES			
Profit (loss) before interest and tax		116.4	(13.3)
Interest income	3	53.6	2.1
Interest expense		(10.6)	(0.4)
Tax	8	(0.2)	–
Depreciation	7	0.6	–
Amortisation of debt securities		(1.2)	–
Employee benefits expense	5, 6	22.5	8.4
Foreign exchange		1.9	(0.3)
Share of profit of associate	12	(3.2)	–
Net realised gains and impairments on investments	3	(0.8)	–
Net unrealised gains on derivative financial instrument	3, 20	(1.8)	–
Unrealised loss on swaps	20	0.9	–
Accrued interest receivable		(5.6)	(2.0)
Unearned premium on premium ceded		(19.1)	–
Deferred acquisition costs		(51.0)	(0.5)
Other receivables		(6.0)	(0.3)
Inwards premium receivable from insureds and cedants		(171.4)	(2.1)
Deferred tax asset		(0.8)	–
Insurance contracts			
– losses and loss adjustment expenses		39.1	–
– unearned premiums		323.1	2.6
– other payables		3.6	–
Amounts payable to reinsurers		2.4	–
Deferred acquisition costs ceded		2.5	–
Other payables		18.6	1.3
Corporation tax payable		1.0	–
Accrued interest payable		–	0.4
Net cash flows from (used in) operating activities		**314.5**	**(4.1)**
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of property, plant and equipment	18	(2.6)	(0.4)
Investment in associate	12	(20.0)	–
Purchase of debt securities		(2,086.1)	–
Purchase of equity securities		(76.1)	–
Proceeds on maturity and disposal of debt securities		1,185.6	–
Proceeds on disposal of equity securities		20.9	–
Net purchase of other investments		(9.7)	–
Net cash flows used in investing activities		**(988.0)**	**(0.4)**
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from issue of share capital		–	978.6
Transaction costs from issue of share capital		–	(12.2)
Formation expenses		–	(15.2)
Proceeds from issue of long term debt		–	125.7
Net cash flows from financing activities		**–**	**1,076.9**
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS		**(673.5)**	**1,072.4**
Cash and cash equivalents at beginning of period		1,072.4	–
Effect of exchange rate fluctuations on cash and cash equivalents		1.2	–
Cash and cash equivalents at end of period	10, 26	**400.1**	**1,072.4**

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The basis of preparation, consolidation principles and significant accounting policies adopted in the preparation of Lancashire Holdings Limited ("LHL") and its subsidiaries' (collectively "the Group") consolidated financial statements are set out below.

BASIS OF PREPARATION

The Group's consolidated financial statements are prepared in accordance with accounting principles generally accepted under International Financial Reporting Standards ("IFRS") endorsed by the European Commission.

Where IFRS is silent, as it is in respect of the measurement of insurance products, the IFRS framework allows reference to another comprehensive body of accounting principles. In such instances, management determines appropriate measurement bases, to provide the most useful information to users of the consolidated financial statements, using their judgment and considering the accounting principles generally accepted in the United States ("US GAAP").

Comparative figures have been presented for the period from October 12, 2005, the date of incorporation, to December 31, 2005. All amounts, excluding share data or where otherwise stated, are in millions of United States ("U.S.") dollars.

The following new or amended standards, which have been issued, but are not yet effective, have not been early adopted by the Group:

- IFRS 7, Financial Instruments Disclosure;
- IFRS 8, Operating Segments;
- IAS 1, Presentation of Financial Statements.

These standards are not expected to have a material impact on the results and disclosures reported in the consolidated financial statements. International Financial Reporting Interpretations Committee ("IFRIC") standards issued but not yet effective are similarly not expected to have a material impact on the results and disclosures of the Group.

The consolidated balance sheet of the Group is presented in order of decreasing liquidity.

USE OF ESTIMATES

The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported and disclosed amounts at the balance sheet date and the reported and disclosed amounts of revenues and expenses during the reporting period. Actual results may differ materially from the estimates made.

BASIS OF CONSOLIDATION

i. Subsidiaries

The Group's consolidated financial statements include the assets, liabilities, equity, revenues, expenses and cash flows of LHL and its subsidiaries. A subsidiary is an entity in which the Group owns, directly or indirectly, more than 50% of the voting power of the entity or otherwise has the power to govern its operating and financial policies. The results of subsidiaries acquired are included in the consolidated financial statements from the date on which control is transferred to the Group. Intercompany balances, profits and transactions are eliminated.

Subsidiaries' accounting policies are consistent with the Group's accounting policies.

ii. Associates

Investments in which the Group has significant influence over the operational and financial policies of the investee, are initially recognised at cost and thereafter accounted for using the equity method. Under this method, the Group records its proportionate share of income or loss from such investments in its results of operations for the period. Adjustments are made to associates' accounting policies, where necessary, in order to be consistent with the Group's accounting policies.

FOREIGN CURRENCY TRANSLATION

The functional currency for all Group entities is U.S. dollars. The consolidated financial statements are presented in U.S. dollars. Items included in the financial statements of each of the Group's entities are measured using the functional currency, which is the currency of the primary economic environment in which operations are conducted.

Foreign currency transactions are recorded in the functional currency for each entity using the exchange rates prevailing at the dates of the transactions, or at the average rate for the period when this is a reasonable approximation. Monetary assets and liabilities denominated in foreign currencies are translated at period end exchange rates. The resulting exchange differences on translation are recorded in the consolidated income statement. Non-monetary assets and liabilities carried at historical cost denominated in a foreign currency are translated at historic rates. Non-monetary assets and liabilities carried at fair value denominated in a foreign currency are translated at the exchange rate at the date the fair value was determined, with resulting exchange differences recorded in the fair value reserves in shareholders' equity.

INSURANCE CONTRACTS

i. Classification

Insurance contracts are those contracts that transfer significant insurance risk at the inception of the contract. Contracts that do not transfer significant insurance risk are accounted for as investment contracts. Insurance risk is transferred when an insurer agrees to compensate a policyholder if a specified uncertain future event adversely affects the policyholder.

ii. Premiums and acquisitions costs

Premiums are first recognised as written at the date that the contract is bound. The Group writes both excess of loss and pro-rata/proportional contracts. For the majority of excess of loss contracts, written premium is recorded based on the minimum and deposit or flat premium, as defined in the contract. Subsequent adjustments to the minimum and deposit premium are recognised in the period in which they are determined. For pro-rata contracts and excess of loss contracts where no deposit is specified in the contract, written premium is recognised based on estimates of ultimate premiums provided by the insureds or ceding companies. Initial estimates of written premium are recognised in the period in which the underlying risks incept. Subsequent adjustments, based on reports of actual premium by the insureds or ceding companies, or revisions in estimates, are recorded in the period in which they are determined.

Premiums are earned ratably over the term of the underlying risk period of the reinsurance contract, except where the period of risk differs significantly from the contract period. In these circumstances, premiums are recognised over the period of risk in proportion to the amount of insurance protection provided. The portion of the premium related to the unexpired portion of the risk period is reflected in unearned premium.

Where contract terms require the reinstatement of coverage after a ceding company's loss, the mandatory reinstatement premiums are recorded as written premium when the loss event occurs.

Inwards premiums receivable from insureds and cedants are recorded net of commissions, brokerage, premium taxes and other levies on premiums. These balances are reviewed for impairment, with any impairment loss recognised in income in the period in which they are determined.

Acquisition costs represent commissions, brokerage, profit commissions and other variable costs that relate directly to the securing of new contracts and the renewing of existing contracts. They are deferred over the period in which the related premiums are earned, to the extent they are recoverable out of expected future revenue margins. All other acquisition costs are recognised as an expense when incurred.

iii. Outwards reinsurance

Outwards reinsurance premiums comprise the cost of reinsurance contracts entered into. Outwards reinsurance premiums are accounted for in the period in which the underlying risks incept. The provision for reinsurers' share of unearned premiums represents that part of reinsurance premiums written which is estimated to be earned in future financial periods. Unearned reinsurance commissions are recognised as a liability using the same principles. Any amounts recoverable from reinsurers are estimated using the same methodology as the underlying losses.

The Group monitors the credit worthiness of its reinsurers on an ongoing basis and assesses any reinsurance assets for impairment, with any impairment loss recognised in income in the period in which it is determined.

iv. Losses

Losses comprise losses and loss adjustment expenses paid in the period and changes in the provision for outstanding losses, including the provision for losses incurred but not reported ("IBNR") and related expenses. Losses and loss adjustment expenses are charged to income as they are incurred.

A significant portion of the Group's business is classes with high attachment points of coverage, including property catastrophe. Reserving for losses in such programs is inherently complicated in that losses in excess of the attachment level of the Group's policies are characterised by high severity and low frequency and other factors which could vary significantly as losses are settled. This limits the volume of industry loss experience available from which to reliably predict ultimate losses following a loss event. In addition, the Group has limited past loss experience due to its short operating history, which increases the inherent uncertainty in estimating ultimate loss levels.

Losses and loss adjustment expenses represent the estimated ultimate cost of settling all losses and loss adjustment expenses arising from events which have occurred up to the balance sheet date, including a provision for IBNR. The Group does not discount its liabilities for unpaid losses. Outstanding losses are initially set on the basis of reports of losses received from third parties. Estimated IBNR reserves consist of a provision for additional development in excess of case reserves reported by ceding companies or insureds, as well as a provision for losses which have occurred but which have not yet been reported to us by ceding companies or insureds. IBNR reserves are estimated by management using various actuarial methods as well as a combination of our own loss experience, historical insurance industry loss experience, our underwriters' experience, estimates of pricing adequacy trends, and management's professional judgment.

The estimation of the ultimate liability arising is a complex and judgmental process. It is reasonably possible that uncertainties inherent in the reserving process, delays in insureds or ceding companies reporting losses to the Group, together with the potential for unforeseen adverse developments, could lead to a material change in losses and loss adjustment expenses.

v. Liability adequacy tests

At each balance sheet date, the Group performs a liability adequacy test using current best estimates of future cash flows generated by its insurance contracts, plus any investment income thereon. If, as a result of these tests, the carrying amount of the Group's insurance liabilities is found to be inadequate, the deficiency is charged to the consolidated income statement for the period initially by writing off deferred acquisition costs and subsequently by establishing a provision.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents are carried in the consolidated balance sheet at cost and includes cash in hand, deposits held on call with banks and other short term highly liquid investments with a maturity of three months or less at the date of purchase. Carrying amounts approximate fair value due to the short term nature of the instruments.

Interest income earned on cash and cash equivalents is recognised on the effective interest rate method. The carrying value of accrued interest income approximates fair value due to its short term nature.

INVESTMENTS

The Group's fixed income and equity investments are classified as available for sale and are carried at fair value. Other investments classified as available for sale are recorded at estimated fair value based on financial information received and other information available to management, including factors restricting the liquidity of the investments. Regular way purchases and sales of investments are recognised at fair value less transaction costs on the trade date and are subsequently carried at fair value. Estimated fair value of quoted investments is determined based on bid prices from recognised exchanges. Investments are derecognised when the Group has transferred substantially all of the risks and rewards of ownership. Realised gains and losses are included in income in the period in which they arise. Unrealised gains and losses from changes in fair value are included in the fair value reserve in shareholders' equity. On derecognition of an investment, previously recorded unrealised gains and losses are removed from shareholders' equity and included in current period income.

Amortisation and accretion of premiums and discounts are calculated using the effective interest rate method and are recognised in current period net investment income. Dividends on equity securities are recorded as revenue on the date the dividends become payable to the holders of record. The carrying value of accrued interest income approximates fair value due to its short term nature.

The Group reviews the carrying value of its investments for evidence of impairment. An investment is impaired if its carrying value exceeds the estimated recoverable amount and there is objective evidence of impairment to the asset. Such evidence would include a prolonged decline in fair value below cost or amortised cost, where other factors do not support a recovery in value. If an impairment is deemed appropriate, the difference between cost or amortised cost and fair value is removed from the fair value reserve in shareholders' equity and charged to current period income.

Impairment losses on equity securities are not subsequently reversed through the income statement. Impairment losses on debt securities may be subsequently reversed through the income statement.

DERIVATIVE FINANCIAL INSTRUMENTS

Derivatives are recognised at fair value on the date a contract is entered into, the trade date, and are subsequently carried at fair value. Derivative instruments with a positive value are recorded as derivative financial assets and those with a negative value are recorded as derivative financial liabilities. Embedded derivatives that are not closely related to their host contract are separated and fair valued through income.

Derivative and embedded derivative financial instruments include swap, option, forward and future contracts. They derive their value from the underlying instrument and are subject to the same risks as that underlying instrument, including liquidity, credit and market risk. Fair values are based on exchange quotations and discounted cash flow models, which incorporate pricing of the underlying instrument, yield curves and other factors, with changes in the fair value of instruments that do not qualify for hedge accounting recognised in current period income.

Derivative financial assets and liabilities are offset and the net amount reported in the consolidated balance sheet only to the extent there is a legally enforceable right of offset and there is an intention to settle on a net basis, or to realise the assets and liabilities simultaneously.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is carried at historical cost, less accumulated depreciation and any impairment in value. Depreciation is calculated to write-off the cost over the estimated useful economic life on a straight-line basis as follows:

IT equipment	33% per annum
Office furniture and equipment	33% per annum
Leasehold improvements	20% per annum

The assets' residual values, useful lives and depreciation methods are reviewed and adjusted if appropriate, at each balance sheet date.

An item of property, plant or equipment is derecognised on disposal or when no future economic benefits are expected to arise from the continued use of the asset.

Gains and losses on the disposal of property, plant and equipment are determined by comparing proceeds with the carrying amount of the asset, and are included in the income statement. Costs for repairs and maintenance are charged to the consolidated income statement as incurred.

LONG TERM DEBT

Long term debt is recognised initially at fair value, net of transaction costs incurred. Thereafter it is held at amortised cost, with the amortisation calculated using the effective interest rate method.

LEASES

Rentals payable under operating leases are charged to income on a straight-line basis over the lease term.

EMPLOYEE BENEFITS

i. Equity compensation plans

The Group operates a management warrant plan and an option plan. The fair value of the equity instrument granted is estimated on the date of grant. The fair value is recognised as an expense pro-rata over the vesting period of the instrument. The total amount to be expensed is determined by reference to the fair value of the awards estimated at the grant date, excluding the impact of any non-market vesting conditions.

At each balance sheet date, the Group revises its estimate of the number of warrants and options that are expected to become exercisable. It recognises the impact of the revision of original estimates, if any, in the consolidated income statement, and a corresponding adjustment is made to shareholders' equity over the remaining vesting period.

On vesting or exercise, the differences between the expense charged to the consolidated income statement and the actual cost to the Group is transferred to retained earnings. Where new shares are issued, the proceeds received are credited to share capital and share premium.

ii. Pensions

The Group operates a defined contribution plan. On payment of contributions to the plan there is no further obligation to the Group. Contributions are recognised as employee benefits in the consolidated income statement in the period to which they relate.

FOUNDER AND SPONSOR WARRANTS

The Group issued warrants to certain founding shareholders and a sponsor on listing. The fair value of the equity instruments granted were estimated on the date of grant.

Warrants issued to founding shareholders were treated as a capital transaction and the associated fair value was credited to the share premium account. The fair value of warrants issued to the sponsor for assistance with incorporation and other start-up services was credited to the share premium account. The total amount to be credited was determined by reference to the fair value of the awards estimated at the grant date, excluding the impact of any non-market vesting conditions.

TAX

Income tax expense represents the sum of the tax currently payable and any deferred tax. The tax payable is calculated based on taxable profit for the period. Taxable profit for the period can differ from that reported in the consolidated income statement due to certain items which are not tax deductible or which are deferred to subsequent periods.

Deferred tax is recognised on temporary differences between the assets and liabilities in the consolidated balance sheet and their tax base. Deferred tax assets or liabilities are accounted for using the balance sheet liability method.

RISK DISCLOSURES: INTRODUCTION

The Group enters into contracts that directly accept and transfer insurance risk. This in turn creates exposure for the Group to insurance risk and financial risk.

The Group's appetite for accepting risk is established by the Board of Directors. The management of risks is described below.

A. INSURANCE RISK

The Group underwrites contracts that transfer insurance risk. The Group's underwriters assess the likely losses using their experience and knowledge of past loss experience and current circumstances. This allows them to estimate the premium sufficient to meet likely losses and expenses. The Group considers insurance risk at an individual contract level and at an aggregate portfolio level. The Group's exposure in connection with such contracts is, in the event of insured losses, whether premium will be sufficient to cover the loss payments and expenses.

The Group underwrites worldwide short tail insurance and reinsurance property risks, including risks exposed to natural catastrophes. The four principal classes, or lines, are property, energy, marine and aviation. The Group does not currently underwrite a significant amount of casualty business. The level of risk tolerance per class is set by the Board of Directors, who delegate day to day responsibility to senior management.

A number of controls are deployed to limit the amount of insurance exposure underwritten:

- A business plan is produced annually which includes target premium by class
- The business plan is monitored and reviewed on an on-going basis
- Each authorised class has a pre-determined normal maximum line structure proposed by management and agreed by the Board
- The Group has a pre-determined target limit on probabilistic loss of capital for certain catastrophic events
- A daily underwriting meeting is held to peer review risks
- Sophisticated pricing models are utilised in the underwriting process, and are updated frequently to latest versions
- Computer modeling tools are deployed to simulate catastrophes and resultant losses to the portfolio
- Reinsurance is purchased to mitigate losses in peak areas of exposure.

The Group has established an internal audit function which is independent of the underwriting process. The head of internal audit reports directly to the Audit Committee. The internal audit function is required to perform risk reviews on the underwriting function to ensure compliance with Group policies and required procedures.

The Group establishes targets for the maximum proportion of capital, including long term debt, that can be lost in a single extreme event. As at December 31, 2006, the impact of an estimated 1 in 250 year California Quake event was 25% of capital, after collection of reinsurance and after payment and collection of reinstatement premiums.

There can be no guarantee that the assumptions and techniques deployed in calculating this figure are accurate. There could also be an unmodeled loss which exceeds these figures. In addition, a California Quake loss event with an occurrence probability of greater than 1 in 250 years could cause a larger loss to capital, as could a different type of loss event with an occurrence probability of less than 1 in 250 years.

The Group commenced underwriting in December 2005, but wrote an insignificant amount of business for the period from incorporation to December 31, 2005. Comparatives have therefore not been presented in the analysis provided in section A: insurance risk.

Details of gross premiums written by line of business are provided below for the year ending December 31, 2006:

	$m	%
Property	254.5	40.6
Energy	253.9	40.6
Marine	53.1	8.5
Aviation	64.5	10.3
Total	**626.0**	**100.0**

Details of gross premiums written by geographic area of risks insured are provided below for the year ending December 31, 2006:

	$m	%
Worldwide offshore	209.4	33.5
Worldwide, including the US[1]	168.2	26.9
USA and Canada	143.5	22.9
Worldwide, excluding the US[2]	32.6	5.2
Far East	19.9	3.2
Rest of world	18.3	2.9
Middle East	17.1	2.7
Europe	17.0	2.7
Total	**626.0**	**100.0**

(1) Worldwide comprises insurance and reinsurance contracts that insure or reinsure risks in more than one geographic area.
(2) Worldwide, excluding the U.S., comprises insurance and reinsurance contracts that insure or reinsure risks in more than one geographic area, but that specifically exclude the United States of America and Canada.

Sections a to d below describe the risks in each of the four principal lines of business written by the Group.

a. Property

Gross premium written, for the year ending December 31, 2006:

	$m
Property retrocession	112.8
Property direct and facultative	111.4
Terrorism	18.9
Property political risk	9.4
Property cat excess of loss	0.6
Other property	1.4
Total	**254.5**

Property retrocession is written on an excess of loss basis through treaty arrangements. Programs are generally written on a pillared basis, with separate geographic zonal limits for risks in the U.S. and Canada and for risks outside the U.S. and Canada. Property cat excess of loss may be written in a similar manner to property retrocession but is not written on a pillared basis. The Group is exposed to large catastrophic losses such as wind and earthquake loss from assuming property retrocession and property cat excess of loss risks. Exposure to such events is controlled and measured through loss modeling but the accuracy of this exposure analysis is limited by the quality of data and effectiveness of the modeling. It is possible that a catastrophic event exceeds the expected event loss. The Group's appetite and exposure guidelines to large losses are set out on page 41. Reinsurance has also been purchased to mitigate gross losses in the U.S. and Canada.

Property direct and facultative is written for the full value of the risk, on a net excess of loss basis. Cover is generally provided to large commercial enterprises with high value locations. Coverage is for non-elemental perils including fire and explosion and elemental (natural catastrophe) perils including flood, windstorm, earthquake and tornado. Coverage generally includes indemnification for both property damage and business interruption.

Terrorism cover is provided for U.S. and worldwide property risks, but excludes nuclear, chemical and biological coverage in most territories.

Political risk cover is written on an individual case by case basis and coverage varies significantly between policies.

b. Energy

Gross premium written, for the year ending December 31, 2006:

	$m
Gulf of Mexico offshore energy	171.8
Worldwide offshore energy	42.3
Construction energy	24.5
Onshore energy	13.5
Other energy	1.8
Total	**253.9**

Energy risks are mostly written on a direct basis. Gulf of Mexico energy programs cover elemental and non-elemental risks. The largest exposure is from hurricanes in the Gulf of Mexico. Exposure to such events is controlled and measured through loss modeling but the accuracy of this exposure analysis is limited by the quality of data and effectiveness of the modeling. It is possible that a catastrophic event exceeds the expected event loss. The Group's appetite and exposure guidelines to large losses are set out on page 41. Policies have sub-limits on coverage for elemental losses, and significant policy restrictions on other areas of cover such as business interruption and control of well. Non-elemental energy risks include fire and explosion. Reinsurance protection has been purchased to protect a portion of loss from elemental energy claims.

Worldwide offshore energy programs are generally for non-elemental risks. Onshore energy risks can include onshore Gulf of Mexico and worldwide energy installations and are largely subject to the same loss events as described above. Energy construction contracts generally cover all risks of platform and drilling units under construction.

c. Marine

Gross premium written, for the year ending December 31, 2006:

	$m
Marine hull and total loss	26.1
Marine builders risk	10.5
Marine P&I clubs	6.4
Marine excess of loss	4.3
Marine hull war	4.1
Other marine	1.7
Total	**53.1**

Marine hull and total loss is generally written on a direct basis and covers marine risks on a worldwide basis primarily for physical damage and loss. Marine P&I is the reinsurance of The International Group of Protection and Indemnity Clubs. Marine excess of loss is generally written on a treaty basis. Marine builders risk is insurance for the building of ocean going vessels in specialised yards worldwide, from keel laying to delivery to owner.

Marine hull war is direct insurance of loss of vessels from war or terrorist attack. Marine cargo programs are not normally written. The largest exposure is from physical loss rather than from elemental loss events.

d. Aviation

Gross premium written, for the year ending December 31, 2006:

	$m
AV52	56.2
Other aviation	8.3
Total	**64.5**

Aviation AV52 provides coverage for third party liability resulting from acts of war or hijack against aircraft.

Other aviation business includes aviation hull war risks and industry loss warranty programs.

REINSURANCE

The Group, in the normal course of business and in accordance with its risk management practices, seeks to reduce the loss that may arise from events that could cause unfavourable underwriting results by entering into reinsurance arrangements. Reinsurance does not relieve the Group of its obligations to policyholders. Under the Group's reinsurance security policy, reinsurers are generally required to be rated A- or better by A.M. Best or equivalent rating. The Group considers reinsurers that are not rated or do not fall within the above rating category on a case by case basis, and may therefore require collateral to be posted to support obligations. The Group monitors the credit worthiness of its reinsurers on an ongoing basis.

In 2006 the Group purchased excess of loss reinsurance, including industry loss warranty covers, and proportional reinsurance. The reinsurance purchased reduced the Group's net exposure to a large natural catastrophe loss in the U.S. which is the Group's largest gross exposure to loss. The Group has not currently purchased reinsurance for risks outside the U.S.

There is no guarantee that reinsurance coverage will be available to meet all potential loss circumstances, as it is possible that the cover purchased is not sufficient. Any loss amount which exceeds the program would be retained by the Group. Some parts of the reinsurance program have limited reinstatements therefore the number of claims which may be recovered from second or subsequent losses is limited.

INSURANCE LIABILITIES

For most insurance and reinsurance companies, the most significant judgment made by management is the estimation of loss and loss adjustment expense reserves. The estimation of the ultimate liability arising from claims made under insurance and reinsurance contracts is a critical estimate for the Group.

Under generally accepted accounting principles, loss reserves are not permitted until the occurrence of an event which may give rise to a claim. As a result, only loss reserves applicable to losses incurred up to the reporting date are established, with no allowance for the provision of a contingency reserve to account for expected future losses. Claims arising from future catastrophic events can be expected to require the establishment of substantial reserves from time to time.

Loss and loss adjustment expense reserves are however maintained to cover the Group's estimated liability for both reported and unreported claims. Reserving methodologies that calculate a point estimate for the ultimate losses are utilised, and then a range is developed around the point estimate. The point estimate represents management's best estimate of ultimate loss and loss adjustment expenses. The Group's internal actuaries review the reserving assumptions and methodologies on a quarterly basis with loss estimates being generally subject to a quarterly corroborative review by independent actuaries, using generally accepted actuarial principles.

The extent of reliance on management judgment in the reserving process differs as to whether the business is insurance or reinsurance, whether it is short-tail or long-tail and whether the business is written on an excess of loss or on a pro-rata basis.
Over a typical annual period, the Group expects to write the majority of programs on a direct basis. Typically, over 80% of programs are expected to be written on an excess of loss basis. The Group does not currently write a significant amount of long-tail business.

a. Insurance versus reinsurance

Loss reserve calculations for direct insurance business are not precise in that they deal with the inherent uncertainty of future contingent events. Estimating loss reserves requires management to make assumptions regarding future reporting and development patterns, frequency and severity trends, claims settlement practices, potential changes in the legal environment and other factors such as inflation. These estimates and judgments are based on numerous factors, and may be revised as additional experience or other data becomes available or reviewed as new or improved methodologies are developed or as current laws change.

Furthermore, as a broker market reinsurer for both excess of loss and proportional contracts, management must rely on loss information reported to brokers by primary insurers who must estimate their own losses at the policy level, often based on incomplete and changing information. The information management receives varies by cedant and may include paid losses, estimated case reserves, and an estimated provision for IBNR reserves. Additionally, reserving practices and the quality of data reporting may vary among ceding companies which adds further uncertainty to the estimation of the ultimate losses.

b. Short-tail versus long-tail

In general, claims relating to short-tail property risks, such as those underwritten by the Group, are reported more promptly by third parties than those relating to long-tail risks, including the majority of casualty risks. However, the timeliness of reporting can be affected by such factors as the nature of the event causing the loss, the location of the loss, and whether the losses are from policies in force with primary insurers or with reinsurers.

c. Excess of loss versus proportional

For excess of loss business, management are aided by the fact that each treaty has a defined limit of liability arising from one event. Once that limit has been reached, there is no further exposure to additional losses from that treaty for the same event. For proportional treaties, generally an initial estimated loss and loss expense ratio (the ratio of losses and loss adjustment expenses incurred to premiums earned) is used, based upon information provided by the insured or ceding company and/or their broker and management's historical experience of that treaty, if any, and the estimate is adjusted as actual experience becomes known.

d. Time lags

There is a time lag inherent in reporting from the original claimant to the primary insurer to the broker and then to the reinsurer, especially in the case of excess of loss reinsurance contracts. Also, the combination of low claim frequency and high severity make the available data more volatile and less useful for predicting ultimate losses. In the case of proportional contracts, reliance is placed on an analysis of a contract's historical experience, industry information, and the professional judgment of underwriters in estimating reserves for these contracts. In addition, if available, reliance is placed partially on ultimate loss ratio forecasts as reported by cedants, which are normally subject to a quarterly or six month lag.

e. Uncertainty

As a result of the time lag described above, an estimation must be made of IBNR reserves, which consist of a provision for additional development in excess of the case reserves reported by ceding companies, as well as a provision for claims which have occurred but which have not yet been reported by ceding companies. Because of the degree of reliance that is necessarily placed on ceding companies for claims reporting, the associated time lag, the low frequency/high severity nature of much of the business that the Group underwrites, and the varying reserving practices among ceding companies, reserve estimates are highly dependent on management judgment and therefore uncertain. During the loss settlement period, which may be years in duration, additional facts regarding individual claims and trends often will become known, and current laws and case law may change, with a consequent impact on reserving.

The claims count on the types of insurance and reinsurance that the Group writes, which are low frequency and high severity in nature, is generally low.

For certain catastrophic events there is greater uncertainty underlying the assumptions and associated estimated reserves for losses and loss adjustment expenses. Complexity resulting from problems such as policy coverage issues, multiple events affecting one geographic area and the resulting impact on claims adjusting (including allocation of claims to event and the effect of demand surge on the cost of building materials and labour) by, and communications from, ceding companies, can cause delays to the timing with which the Group is notified of changes to loss estimates.

In the year to December 31, 2006, management were not notified or made aware of any losses of a material size. As such, at December 31, 2006 management's estimates for IBNR represented approximately 97% of total loss reserves.

The majority of the estimate relates to potential claims on non-elemental risks where timing delays in cedant reporting may mean losses have occurred which management were not made aware of by December 31, 2006.

B. FINANCIAL RISK DISCLOSURES

The Group is exposed if proceeds from financial assets are not sufficient to fund obligations arising from its insurance contracts.

The Group segments its investment portfolio into two main components: a category to at least meet expected insurance liabilities ("core portfolio") and a balancing category which represents funds in excess of the core portfolio ("surplus portfolio").

The core portfolio needs to be sufficiently liquid to settle claims. The core portfolio is invested in fixed income securities and cash and cash equivalents, with a bias towards shorter durations and higher quality assets.

The surplus portfolio is invested in fixed income securities, cash and cash equivalents and a modest amount of equity securities. Currently, the Group does not hold any alternative investments such as hedge funds. The surplus portfolio has a modest holding of convertible debt securities. These instruments have been bifurcated into their component parts with the embedded option fair valued through the income statement.

Investment guidelines are established by the Investment Committee of the Board of Directors. Separate investment guidelines exist for the core portfolio, the surplus portfolio and the Group's consolidated portfolio. Investment guidelines set parameters within which investment managers must operate. Important parameters include guidelines on permissible assets, duration ranges, credit quality and maturity. Investment guidelines are monitored on a monthly basis.

Asset allocation is as follows:

	December 31, 2006			December 31, 2005		
	$m	$m	$m	$m	$m	$m
	Core	**Surplus**	**Total**	**Core**	**Surplus**	**Total**
Fixed income securities	466.0	430.3	896.3	–	–	–
Equity securities	5.7	64.6	70.3	–	–	–
Other investments	–	11.5	11.5	–	–	–
Cash	306.6	93.5	400.1	1,072.4	–	1,072.4
Total	**778.3**	**599.9**	**1,378.2**	**1,072.4**	**–**	**1,072.4**

	%	%	%	%	%	%
Fixed income securities	33.8	31.2	65.0	–	–	–
Equity securities	0.4	4.7	5.1	–	–	–
Other investments	–	0.8	0.8	–	–	–
Cash	22.3	6.8	29.1	100.0	–	100.0
Total	**56.5**	**43.5**	**100.0**	**100.0**	**–**	**100.0**

The investment mix of the fixed income portfolio is as follows:

	December 31, 2006			December 31, 2005		
	$m	$m	$m	$m	$m	$m
	Core	**Surplus**	**Total**	**Core**	**Surplus**	**Total**
Short term investments	2.1	4.8	6.9	–	–	–
U.S. treasuries	15.0	15.8	30.8	–	–	–
U.S. government agencies	102.1	48.3	150.4	–	–	–
Asset backed securities	80.8	40.3	121.1	–	–	–
Mortgage backed securities	140.6	226.5	367.1	–	–	–
Corporate bonds	125.4	65.7	191.1	–	–	–
Convertible debt securities	–	28.9	28.9	–	–	–
Total	**466.0**	**430.3**	**896.3**	**–**	**–**	**–**

	%	%	%	%	%	%
Short term investments	0.2	0.5	0.7	–	–	–
U.S. treasuries	1.7	1.8	3.5	–	–	–
U.S. government agencies	11.4	5.4	16.8	–	–	–
Asset backed securities	9.0	4.5	13.5	–	–	–
Mortgage backed securities	15.7	25.3	41.0	–	–	–
Corporate bonds	14.0	7.3	21.3	–	–	–
Convertible debt securities	–	3.2	3.2	–	–	–
Total	**52.0**	**48.0**	**100.0**	**–**	**–**	**–**

Both the core and surplus fixed income portfolios are managed by two external investment managers with identical mandates. The equity portfolio is managed by one investment manager. The equity portfolio is invested predominantly in U.S. and Canadian securities in a diversified range of sectors. The performance of the managers is monitored on an on-going basis.

An analysis of the most important components of financial risk is detailed in a to e below.

a. Valuation risk

The Group's net asset value is directly impacted by movements in the value of investments held. Values can be impacted by movements in interest rates, credit ratings, economic environment and outlook, and exchange rates.

The impact of a 10% fall in the value of the Group's equity portfolio at December 31, 2006 would be $7.0 million. Valuation risk in the equity portfolio is mitigated by adopting a value strategic approach and by diversifying the portfolio across sectors.

b. Interest rate risk

The majority of the Group's investments comprise fixed income securities. The fair value of the Group's fixed income portfolio is inversely correlated to movements in market interest rates. If market interest rates fall, the fair value of the Group's fixed income investments would tend to rise and vice versa.

The sensitivity of the price of fixed income securities is indicated by its duration[1]. The greater a security's duration, the greater its percentage price volatility.

The sensitivity of the Group's fixed income portfolio at December 31, 2006 to interest rate movements is as follows:

Immediate shift in yield (basis points)	%	$m
100	-2.3	(21.0)
75	-1.7	(15.8)
50	-1.2	(10.5)
25	-0.6	(5.3)
-25	0.6	5.3
-50	1.2	10.5
-75	1.7	15.8
-100	2.3	21.0

The Board limits interest rate risk on its investment portfolio by establishing and monitoring duration ranges within investment guidelines. The duration of the fixed income portfolios at December 31, 2006 was 1.5 years for the core portfolio and 3.2 years for the surplus portfolio.

Insurance contract liabilities are not directly sensitive to the level of market interest rates, as they are undiscounted and contractually non-interest bearing.

(1) Duration is the weighted average maturity of a security's cash flows, where the present values of the cash flows serve as the weights.

The Group has issued long term debt as described in note 19. The loan notes bear interest at a floating rate plus a fixed margin of 3.7%. The Group is subject to interest rate risk on the coupon payments of the long term debt. The Group has mitigated the interest rate risk by entering into swap contracts as follows:

	Maturity date	Prepayment date[(1)]	Interest hedged[(2)]
Subordinated loan notes €24 million	June 15, 2035	March 15, 2011	50%
Subordinated loan notes $97 million	December 15, 2035	December 15, 2011	50%

(1) The subordinated note can be prepaid from December 16, 2005, with a sliding scale redemption price penalty which reduces to zero by December 15, 2011.
(2) The Group has entered into swaps to fix the interest rate on 50% of the principal through the prepayment dates specified above.

The current Euribor interest rate on 50% of the subordinated loan notes has been fixed at 3.67%. The current LIBOR interest rate on 50% of the subordinated loan notes has been fixed at 5.36%. The Group retains exposure to interest risk on the remaining portion of the notes.

c. Liquidity risk

The Group can be exposed to daily calls on its available investment assets, principally from insurance claims. Liquidity risk is the risk that cash may not be available to pay obligations when they are due without incurring an unreasonable cost.

The maturity dates of the Group's fixed income portfolio at December 31, 2006 were as follows:

	$m	$m	$m
	Core	**Surplus**	**Total**
Less than one year	21.3	–	21.3
Between one year and two years	117.8	28.9	146.7
Between two and three years	79.0	21.7	100.7
Between three and four years	56.5	42.0	98.5
Between four and five years	16.7	35.2	51.9
Over five years	174.7	302.5	477.2
Total	**466.0**	**430.3**	**896.3**

Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay certain obligations with or without call or prepayment penalties.

The Board limits liquidity risk in several ways. First, a portion of the investment portfolio is segregated for the short term liquidity requirements arising from insurance obligations. The core portfolio is highly liquid with short maturity. All core portfolio securities are quoted on major exchanges. Secondly, the Board has established asset allocation and maturity parameters within investment guidelines such that the majority of the Group's investments are in high quality assets which could be converted into cash promptly and at minimal expense.

d. Currency risk

The Group currently underwrites out of two locations, Bermuda and London. However, risks are assumed on a worldwide basis. Risks assumed are predominantly denominated in U.S. dollars. The Group is exposed to currency risk to the extent its assets are denominated in different currencies to its liabilities. The Group is also exposed to non-retranslation risk on non-monetary assets such as unearned premiums. At each balance sheet date exchange gains and losses can impact the consolidated income statement.

The Group has hedged the large majority of currency risk by closely matching the non U.S. dollar liabilities with non U.S. dollar assets. The Group's main foreign currency exposure relates to its insurance obligations and the €24 million subordinated notes long term debt liability. While the unhedged balances are not large, the Group has more closely hedged these currency exposures by holding larger balances of non U.S. dollar cash.

The Group's assets and liabilities, categorised by currency at their translated carrying amount was as follows:

ASSETS	**$m**	**$m**	**$m**	**$m**	**$m**
	U.S. $	**Sterling**	**Euro**	**Other**	**Total**
Cash and cash equivalents	359.0	1.3	37.1	2.7	400.1
Accrued interest receivable	7.5	–	–	–	7.5
Investments	978.1	–	–	–	978.1
Unearned premium on premium ceded	19.1	–	–	–	19.1
Deferred acquisition costs	48.5	0.2	1.6	1.2	51.5
Other receivables	5.1	1.2	–	–	6.3
Inwards premium receivable from insureds	161.6	0.7	5.6	5.8	173.7
Deferred tax asset	–	0.8	–	–	0.8
Investment in associate	23.2	–	–	–	23.2
Property, plant and equipment	1.4	1.0	–	–	2.4
Total assets as at December 31, 2006	**1,603.5**	**5.2**	**44.3**	**9.7**	**1,662.7**

LIABILITIES	**$m**	**$m**	**$m**	**$m**	**$m**
	U.S. $	**Sterling**	**Euro**	**Other**	**Total**
Losses and loss adjustment expenses	38.0	0.2	0.9	–	39.1
Unearned premiums	304.9	2.0	10.4	8.4	325.7
Insurance contracts – other payables	3.6	–	–	–	3.6
Amounts payable to reinsurers	2.4	–	–	–	2.4
Deferred acquisition costs ceded	2.5	–	–	–	2.5
Other payables	19.8	1.0	–	–	20.8
Corporation tax payable	–	1.0	–	–	1.0
Interest rate swap	1.0	–	(0.1)	–	0.9
Accrued interest payable	0.4	–	0.1	–	0.5
Long term debt	97.0	–	31.6	–	128.6
Total liabilities as at December 31, 2006	**469.6**	**4.2**	**42.9**	**8.4**	**525.1**

ASSETS	$m	$m	$m	$m	$m
	U.S. $	Sterling	Euro	Other	Total
Cash and cash equivalents	1,072.4	–	–	–	1,072.4
Accrued interest receivable	2.0	–	–	–	2.0
Deferred acquisition costs	0.5	–	–	–	0.5
Other receivables	0.3	–	–	–	0.3
Inwards premium receivable from insureds	2.1	–	–	–	2.1
Property, plant and equipment	0.4	–	–	–	0.4
Total assets as at December 31, 2005	**1,077.7**	**–**	**–**	**–**	**1,077.7**

LIABILITIES	$m	$m	$m	$m	$m
	U.S. $	Sterling	Euro	Other	Total
Unearned premiums	2.6	–	–	–	2.6
Other payables	2.2	–	–	–	2.2
Accrued interest payable	0.4	–	–	–	0.4
Long term debt	97.0	–	28.4	–	125.4
Total liabilities as at December 31, 2005	**102.2**	**–**	**28.4**	**–**	**130.6**

e. Credit risk

Credit risk is the risk that a counterparty may fail to pay, or repay, a debt or obligation. The Group is exposed to credit risk on its fixed income investment portfolio, its inwards premium receivable from insureds and cedants, and on any amounts recoverable from reinsurers.

Credit risk on the fixed income portfolio is managed by establishing investment guidelines that set parameters on the absolute credit ratings of holdings and the concentration of holdings within credit rating bands. The guidelines also place limits on the size of investment in a single issuer or class of issuer. Compliance with guidelines is regularly monitored.

Credit risk from reinsurance recoverables is primarily managed by review and approval of reinsurer security by the Group's reinsurance security committee as discussed on page 44.

The table below presents an analysis of the Group's major exposures to counterparty credit risk, based on Standard & Poor's or equivalent rating. The table includes amounts due from policyholders and unsettled investment trades. The quality of these receivables is not graded, but based on management's historical experience there is limited default risk associated with these amounts. Outstanding claims, including IBNR, recoverable from reinsurers was nil at December 31, 2006 and December 31, 2005, and therefore has not been included.

	December 31, 2006		December 31, 2005	
	$m	$m	$m	$m
	Cash and fixed income	Premium and other receivables	Cash and fixed income	Premium and other receivables
AAA	1,018.8	–	1,072.4	–
AA+, AA, AA-	43.6	–	–	–
A+, A, A-	173.8	–	–	–
BBB+, BBB, BBB-	51.9	–	–	–
Other	8.3	180.0	–	2.4
	1,296.4	**180.0**	**1,072.4**	**2.4**

1. GENERAL INFORMATION

The Group is a provider of global property insurance and reinsurance products. LHL was incorporated under the laws of Bermuda on October 12, 2005. LHL is listed on the Alternative Investment Market ("AIM"), a subsidiary market of the London Stock Exchange. The registered office of LHL is Clarendon House, 2 Church Street, Hamilton HM 11, Bermuda. LHL has four wholly owned subsidiaries: Lancashire Insurance Company Limited ("LICL"), Lancashire Insurance Holdings (UK) Limited ("LIHUKL"), Lancashire Insurance Marketing Services Limited ("LIMSL") and Lancashire Insurance Services Limited ("LISL"). LIHUKL is a holding company for a wholly owned operating subsidiary, Lancashire Insurance Company (UK) Limited ("LICUKL").

LICL and LICUKL are currently the Group's principal operating subsidiaries. LICL was incorporated under the laws of Bermuda on October 28, 2005 and is authorised by the Bermuda Monetary Authority (the "BMA") as a Class 4 general insurer. LICL provides insurance and reinsurance products to its customers, with an emphasis on property, energy, marine and aviation lines of business. LICUKL was incorporated under the laws of England & Wales on March 17, 2006 and is authorised by the United Kingdom Financial Services Authority (the "FSA") to conduct general insurance business. The products provided are the same as those provided by LICL. LICUKL is also registered as a Class 3 general insurer in Bermuda and has a permit issued under the Bermuda Companies Act to enable certain activities related to its insurance business to be performed from Bermuda.

LIMSL is authorised by the FSA to undertake insurance mediation activities. LIMSL provides business introduction and other support services to LICL in the United Kingdom, and was incorporated under the laws of England & Wales on October 7, 2005.

LISL was incorporated under the laws of England & Wales on March 17, 2006. LISL provides support services to LIMSL and LICUKL.

2.
SEGMENTAL REPORTING

Management and the Board review the Group's business primarily by its four principal classes: property, energy, marine and aviation. Management has therefore deemed these classes to be its business and primary segments for the purposes of segmental reporting. Further sub classes of business are underwritten within each primary segment. The Group commenced underwriting in December 2005, but wrote an insignificant amount of business in the period from incorporation to December 31, 2005. Comparatives have therefore not been presented for segments.

REVENUE AND EXPENSE BY BUSINESS SEGMENT

GROSS PREMIUMS WRITTEN	$m	$m	$m	$m	$m
	Property	Energy	Marine	Aviation	Total
ANALYSED BY GEOGRAPHICAL SEGMENT:					
Worldwide offshore	–	175.5	33.9	–	209.4
Worldwide including the U.S.	71.5	26.2	7.4	63.1	168.2
U.S. and Canada	111.7	31.4	0.4	–	143.5
Worldwide excluding the U.S.	31.4	0.5	0.6	0.1	32.6
Far East	10.6	2.6	6.7	–	19.9
Rest of world	10.3	6.8	–	1.2	18.3
Middle East	6.7	9.0	1.3	0.1	17.1
Europe	12.3	1.9	2.8	–	17.0
Total	**254.5**	**253.9**	**53.1**	**64.5**	**626.0**
Outwards reinsurance premiums	(39.8)	(38.7)	–	–	(78.5)
Change in unearned premiums	(123.5)	(119.4)	(28.8)	(51.4)	(323.1)
Change in unearned premiums ceded	7.3	11.8	–	–	19.1
Net premiums earned	**98.5**	**107.6**	**24.3**	**13.1**	**243.5**
Insurance losses and loss adjustment expenses	(13.2)	(17.2)	(8.7)	–	(39.1)
Insurance acquisition expenses	(12.7)	(20.1)	(4.6)	(2.6)	(40.0)
Insurance acquisition expenses ceded	1.5	3.6	–	–	5.1
Net underwriting profit	**74.1**	**73.9**	**11.0**	**10.5**	**169.5**
Net investment income					54.2
Other investment income					1.8
Net realised gains (losses) and impairments					0.8
Share of profit of associate					3.2
Net foreign exchange gains (losses)					(1.3)
Operating expenses unrelated to underwriting					(33.9)
Equity based compensation					(22.5)
Finance costs					(12.3)
Profit before tax					**159.5**
Tax					(0.2)
Profit for the period attributable to equity shareholders					**159.3**

2.
SEGMENTAL REPORTING CONTINUED

	%	%	%	%	%
	Property	**Energy**	**Marine**	**Aviation**	**Total**
Loss ratio	13.4	16.0	35.8	–	16.1
Acquisition cost ratio	11.4	15.3	18.9	19.8	14.3
Expense ratio	–	–	–	–	13.9
Combined ratio	**24.8**	**31.3**	**54.7**	**19.8**	**44.3**

ASSETS AND LIABILITIES BY BUSINESS SEGMENT

ASSETS	**$m**	**$m**	**$m**	**$m**	**$m**
	Property	**Energy**	**Marine**	**Aviation**	**Total**
Attributable to business segments	82.2	82.7	29.3	57.0	251.2
Other assets					1,411.5
Total assets					**1,662.7**

LIABILITIES	**$m**	**$m**	**$m**	**$m**	**$m**
	Property	**Energy**	**Marine**	**Aviation**	**Total**
Attributable to business segments	128.8	154.6	38.2	51.7	373.3
Other liabilities					151.8
Total liabilities					**525.1**
Total net assets					**1,137.6**

The Group's net assets are located primarily in Bermuda. Less than 10% of total net assets are currently attributable to the UK operations.

3.
INVESTMENT RETURN

The total investment return for the Group is as follows:

	2006 $m	2005 $m
Investment income		
– interest on fixed income securities	33.3	–
– net amortisation of premium (discount)	3.2	–
– interest income on cash and cash equivalents	19.2	2.1
– dividends from equity securities	0.8	–
– investment management and custodian fees	(2.3)	–
Net investment income	**54.2**	**2.1**
– net realised and unrealised gains (losses)	1.8	–
Net other investment income	**1.8**	**–**
Net realised gains (losses) and impairments		
– fixed income securities	(2.4)	–
– equity securities	3.2	–
Net realised gains (losses) and impairments	**0.8**	**–**
Net unrealised gains (losses) recognised in shareholders' equity		
– fixed income securities	2.6	–
– equity securities	6.1	–
Net unrealised gains (losses) recognised in shareholders' equity	**8.7**	**–**
Total investment return	**65.5**	**2.1**

Net realised gains (losses) on equity securities includes an impairment loss of $0.4 million (2005 – $nil) recognised on one equity investment held by the Group at December 31, 2006.

4.
NET INSURANCE ACQUISITION EXPENSES

	2006 $m	2005 $m
Insurance acquisition expenses	91.0	0.5
Changes in deferred insurance acquisition expenses	(51.0)	(0.5)
Insurance acquisition expenses ceded	(7.6)	–
Changes in deferred insurance acquisition expenses ceded	2.5	–
Total	**34.9**	**–**

5.
OTHER OPERATING EXPENSES

	2006 $m	2005 $m
Operating expenses unrelated to underwriting	33.9	1.6
Equity based compensation	22.5	8.4
Total	**56.4**	**10.0**

6.
EMPLOYEE BENEFITS

	2006 $m	2005 $m
Wages and salaries	5.4	0.2
Pension costs	0.6	–
Other benefits	7.5	–
Equity based compensation	22.5	8.4
Total	**36.0**	**8.6**

As at December 31, 2006, the Group had 54 (2005 – 4) employees.

EQUITY BASED COMPENSATION

There are two forms of equity based compensation: warrants and a long term incentive plan.

On admission to AIM, warrants to purchase common shares were issued for immediate allocation to certain members of management or reserved for later allocation to employees of the Group. There are two forms of warrant: Management Team Ordinary Warrants and Management Team Performance Warrants.

All warrants issued to management expire on December 16, 2015 and will be exercisable at an initial price per share of US$5.00 equal to the price per share paid by investors in the initial public offering. Settlement is at the discretion of the Group and may be in cash or shares.

MANAGEMENT TEAM ORDINARY WARRANTS ("ORDINARY WARRANTS")

Ordinary warrants do not have associated performance criteria. 25% of such warrants vested immediately upon issuance. Thereafter, 25% of such warrants will vest on the first, second and third anniversary of the grant date.

On December 16, 2005, the Board approved the issue of ordinary warrants to purchase 12,708,695 common shares, representing the full allocation of management team ordinary warrants. Warrants from this amount were subsequently awarded to individual members of management and staff.

MANAGEMENT TEAM PERFORMANCE WARRANTS ("PERFORMANCE WARRANTS")

Performance warrants vest over a four year period and are dependent on certain performance criteria with specific measurement dates of December 31, 2007, December 31, 2008 and December 31, 2009. Half of these warrants will vest only on achievement of a fully diluted book value per share in comparison to a planned appreciation threshold of between 70% and 100% at certain dates. The remaining half of these warrants will vest only on achievement of an internal rate of return ("IRR") in comparison to a planned IRR of between 70% and 100% at certain dates.

6.
EMPLOYEE BENEFITS CONTINUED

On December 16, 2005, the Board approved the issue of performance warrants to purchase 7,625,218 common shares, representing the full allocation of management team performance warrants. Warrants from this amount were subsequently awarded to individual members of management.

The fair value of each warrant was estimated on the date of grant using the Black-Scholes option-pricing model. Assumptions used for valuation of these grants were as follows: risk free interest rate of 4.93%; an expected life of ten years; volatility of 30% being the maximum contractual rate; performance targets will be fully met; dividend yield of nil due to contractual dividend protection; the Group will settle in shares; no dilutive events, and no forfeitures, other than leavers which are assumed to be 10% of total employees for management performance warrants during all vesting periods and 10% of the 2007 and 2008 vesting periods relating to ordinary warrants expensed in 2006. For the ordinary warrants that vested in 2006, there was no leavers' adjustment as no holders of these warrants had left the Group.

Warrants	Number (thousands)	Weighted average exercise price (US$)
Allocated as at December 31, 2005	14,463	$5.00
Allocated during the period	4,834	$5.00
Allocated as at December 31, 2006	19,297	$5.00
Exercisable at December 31, 2006	6,030	$5.00

The fair value of warrants granted for the period ended December 31, 2005 was $2.62 per share. There were no further issues in 2006. A share-based payment expense of $20.5 million (2005 – $8.4 million) is included in other operating expenses in the consolidated income statement.

LONG TERM INCENTIVE PLAN ("LTIP")

Options may be granted under the LTIP at the discretion of the Remuneration Committee. Options granted under the LTIP are limited to 5% of the fully diluted common share capital in issue at the date of grant. All options issued will expire ten years from date of issue and the exercise price is equal to or greater than the average market value of the shares on the twenty previous trading days prior to grant.

The range of exercise prices for options at December 31, 2006 was £3.25 ($6.37) to £3.55 ($6.95) per share. 25% of options vest on each of the first, second, third and fourth anniversary of the grant date. There are no associated performance criteria. Settlement is at the discretion of the Group and may be in cash or shares.

In 2006, certain members of staff were issued options to purchase 2,503,613 common shares. Options to purchase 101,670 common shares were forfeited during the period (see note 22).

The fair value of each option was estimated on the date of grant using the Black-Scholes option-pricing model. Assumptions used for valuation of these grants were as follows: risk free interest rate of 5.125%; an expected life of six years; volatility of 30% being the maximum contractual rate; dividend yield of nil due to contractual dividend protection; the Group will settle in shares; no forfeitures, other than leavers which are assumed to be 10% of total employees, and no dilutive events.

Options	Number (thousands)	Weighted average exercise price (US$)
Granted during the period and outstanding as at December 31, 2006	2,402	$5.77
Exercisable at December 31, 2006	–	–

The weighted fair value of options granted during the period ended December 31, 2006 was $2.32 per option. A share-based payment expense of $2.0 million (2005 – $nil) is included in other operating expenses in the consolidated income statement.

7.
RESULTS OF OPERATING ACTIVITIES

Results of operating activities are stated after charging the following amounts:

	2006 $m	2005 $m
Depreciation on owned assets	0.6	–
Operating lease charges	1.1	–
Auditors' remuneration		
– Group audit fees	0.7	0.1
– other services	0.3	0.6
Total	**2.7**	**0.7**

Fees paid to the Group's auditors for other services are approved by the Group's Audit Committee. Such fees comprise the following amounts:

	2006 $m	2005 $m
Tax advice	0.1	–
FSA regulatory advice	0.2	–
Other	–	0.6
Total	**0.3**	**0.6**

8.
TAX

BERMUDA

LHL, LICL and LICUKL have received an undertaking from the Bermuda government exempting them from all Bermuda local income, withholding and capital gains taxes until March 28, 2016. At the present time no such taxes are levied in Bermuda.

UNITED STATES

The Group does not consider itself to be engaged in trade or business in the United States and, accordingly, does not expect to be subject to United States taxation.

UNITED KINGDOM

The UK subsidiaries are subject to normal UK corporation tax on all their profits.

	2006 $m	2005 $m
Current tax expense	1.0	–
Deferred tax credit (note 9)	(0.8)	–
Total	**0.2**	**–**

In the period to December 31, 2005 the Group did not incur a UK corporation tax liability.

The standard rate of corporation tax in the UK is 30% (2005 – 30%). The current tax charge as a percentage of the Group's profit before tax is 0.1% (2005 – nil) due to the different tax paying jurisdictions throughout the Group.

9. DEFERRED TAX

	2006 $m	2005 $m
Deferred tax assets	0.8	–
Deferred tax liabilities	–	–
Net deferred tax asset	**0.8**	**–**

Deferred tax is calculated in full on temporary differences under the balance sheet liability method using a tax rate of 30%. Deferred tax assets are recognised to the extent that realisation of the related tax benefit through future taxable profits is likely. Deferred tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred income taxes relate to the same fiscal authority.

The deferred tax asset relates to the warrants and options benefit scheme. These temporary differences are unlikely to reverse in the foreseeable future. All deferred tax assets and liabilities are classified as non current.

The movement on the total net deferred tax asset is as follows:

	2006 $m	2005 $m
As at January 1, 2006	–	–
Income statement credit	0.8	–
As at December 31, 2006	**0.8**	**–**

Deferred tax assets were comprised of the following:

	2006 $m	2005 $m
Share warrants and options	0.8	–
As at December 31, 2006	**0.8**	**–**

As at December 31, 2006, deferred tax liabilities were negligible (2005 – $nil).

10. CASH AND CASH EQUIVALENTS

	2006 $m	2005 $m
Cash at bank and in hand	50.0	12.2
Cash equivalents	350.1	1,060.2
Total	**400.1**	**1,072.4**

Cash equivalents have an original maturity of three months or less. The carrying amount of these assets approximates their fair value.

Cash and cash equivalents totaling $10.9 million (2005 – $5.4 million) were on deposit in various trust accounts for the benefit of policyholders or counterparties to agreements to cover their credit risk.

Cash and cash equivalents totaling $25.1 million (2005 – $nil) were on deposit as collateral in favour of letters of credit issued for the benefit of policyholders or counterparties to cover their credit risk.

11.
INVESTMENTS

As at December 31, 2006	Cost or amortised cost $m	Gross unrealised gain $m	Gross unrealised loss $m	Estimated fair value $m
FIXED INCOME SECURITIES				
– short term investments	6.9	–	–	6.9
– U.S. treasuries	30.8	–	–	30.8
– U.S. government agencies	150.3	0.2	(0.1)	150.4
– asset backed securities	121.0	0.2	(0.1)	121.1
– mortgage backed securities	365.6	2.0	(0.5)	367.1
– corporate bonds	190.2	1.1	(0.2)	191.1
– convertible debt securities	28.9	–	–	28.9
Total fixed income securities	893.7	3.5	(0.9)	896.3
Equity securities	64.2	7.0	(0.9)	70.3
Other investments	9.7	1.9	(0.1)	11.5
Total	**967.6**	**12.4**	**(1.9)**	**978.1**

Equity securities and other investments are generally deemed non-current. Fixed income maturities are presented in the risk disclosures section on page 48.

In 2005 the Group's invested assets were held entirely in cash and cash equivalents. Comparatives for the above table have therefore not been presented.

12.
INVESTMENT IN ASSOCIATE

On June 15, 2006 the Group made an investment of $20.0 million which represents a 21% interest in Sirocco Holdings Limited ("Sirocco"), a company incorporated in Bermuda. Sirocco's operating subsidiary, Sirocco Reinsurance Limited ("Sirocco Re"), is authorised as a Class 3 insurer by the Bermuda Monetary Authority. Sirocco Re was established to assume Gulf of Mexico energy risks from the Group. Sirocco is an unquoted investment and its shares do not trade on any active market. Sirocco is carried at $23.2 million, representing management's best estimate of fair value at December 31, 2006, based on the July 15, 2006 audited financial statements and subsequent management information.

	2006 $m
As at January 1, 2006	–
Acquisition	20.0
Share of profit of associate	3.2
As at December 31, 2006	**23.2**

12.
INVESTMENT IN ASSOCIATE CONTINUED

Investments in associates are generally deemed non-current. Key financial information for Sirocco for the period from May 22, 2006 (date of incorporation) to December 31, 2006 is as follows:

	$m
Assets	124.6
Liabilities	14.3
Revenues	18.6
Profit	15.2

13.
INSURANCE AND REINSURANCE CONTRACTS

INSURANCE LIABILITIES	Losses and loss adjustment expenses $m	Unearned premiums $m	Other payables $m	Total $m
As at October 12, 2005 (date of incorporation)	–	–	–	–
Movement in period	–	2.6	–	2.6
Exchange adjustments	–	–	–	–
As at December 31, 2005	**–**	**2.6**	**–**	**2.6**
Movement in period	39.1	323.1	3.6	365.8
Exchange adjustments	–	–	–	–
As at December 31, 2006	**39.1**	**325.7**	**3.6**	**368.4**

REINSURANCE ASSETS AND LIABILITIES	Unearned premiums ceded $m	Amounts payable to reinsurers $m	Total $m
As at October 12, 2005 (date of incorporation)	–	–	–
Movement in period	–	–	–
Exchange adjustments	–	–	–
As at December 31, 2005	**–**	**–**	**–**
Movement in period	19.1	(2.4)	16.7
Exchange adjustments	–	–	–
As at December 31, 2006	**19.1**	**(2.4)**	**16.7**

Further information on the calculation of loss reserves and the risks associated with them is provided in the risk disclosures section, which starts on page 41. The risks associated with general insurance contracts are complex and do not readily lend themselves to meaningful sensitivity analysis. The impact of an unreported event could lead to a significant increase in our loss reserves. Management believe that the loss reserves established as at December 31, 2006 are adequate, however a 20% increase in estimated losses would lead to a $7.8 million (2005 – $nil) increase in loss reserves.

13.
INSURANCE AND REINSURANCE CONTRACTS CONTINUED

The split of losses and loss adjustments expenses between notified outstanding losses and losses incurred but not reported is shown below:

	2006 $m	2005 $m
Outstanding losses	1.2	–
Losses incurred but not reported	37.9	–
Losses and loss adjustment expenses reserves	**39.1**	**–**

It is estimated that our reserve for unpaid claims and adjustment expenses has an approximate duration of one year.

CLAIMS DEVELOPMENT

The development of insurance liabilities is indicative of the Group's ability to estimate the ultimate value of its insurance liabilities. The Group began writing insurance and reinsurance business in December 2005. Due to the underlying risks and lack of known loss events occurring during the period to December 31, 2005, the Group does not expect to incur any losses from coverage provided in 2005. Accordingly, a loss development table has not been included.

14.
INSURANCE AND OTHER RECEIVABLES

	2006 $m	2005 $m
Inwards premium receivable from insureds and cedants	173.7	2.1
Accrued interest receivable	7.5	2.0
Other receivables	6.3	0.3
Total receivables	**187.5**	**4.4**

Other receivables consist primarily of unsettled investment trades. All receivables are considered current other than $8.9 million (2005 – $nil) of inwards premium receivable related to multi-year contracts. The carrying value approximates fair value due to the short term nature of the receivables. There are no provisions in place for impairment or irrecoverable balances. There is no significant concentration of credit risk within the Group's receivables.

15. DEFERRED ACQUISITION COSTS

The reconciliation between opening and closing deferred acquisition costs is shown below:

	$m
Balance as at October 12, 2005 (date of incorporation)	–
Movement in period	0.5
Balance as at December 31, 2005	**0.5**
Movement in period	51.0
Balance as at December 31, 2006	**51.5**

16. REINSURANCE AND OTHER PAYABLES

	2006 $m	2005 $m
Other payables	20.8	2.2
Insurance contracts – other payables	3.6	–
Amounts payable to reinsurers	2.4	–
Total payables	**26.8**	**2.2**

Other payables include unsettled investment trades and other accruals. All payables are considered current. The carrying value approximates fair value due to the short term value of the payables.

17. DEFERRED ACQUISITION COSTS CEDED

The reconciliation between opening and closing deferred acquisition costs ceded is shown below:

	$m
Balance as at October 12, 2005 (date of incorporation)	–
Movement in period	–
Balance as at December 31, 2005	**–**
Movement in period	2.5
Balance as at December 31, 2006	**2.5**

18.
PROPERTY, PLANT AND EQUIPMENT

	Office furniture and equipment $m	Leasehold improvements $m	IT equipment $m	Total $m
COST				
As at October 12, 2005 (date of incorporation)	–	–	–	–
Additions	–	–	0.4	0.4
As at December 31, 2005	**–**	**–**	**0.4**	**0.4**
ACCUMULATED DEPRECIATION				
As at October 12, 2005 (date of incorporation)	–	–	–	–
Charge for the period	–	–	–	–
As at December 31, 2005	**–**	**–**	**–**	**–**
NET BOOK VALUE				
As at October 12, 2005 (date of incorporation)	–	–	0.4	0.4
As at December 31, 2005	**–**	**–**	**0.4**	**0.4**
COST				
As at January 1, 2006	–	–	0.4	0.4
Additions	1.0	0.6	1.0	2.6
As at December 31, 2006	**1.0**	**0.6**	**1.4**	**3.0**
ACCUMULATED DEPRECIATION				
As at January 1, 2006	–	–	–	–
Charge for the period	0.2	0.1	0.3	0.6
As at December 31, 2006	**0.2**	**0.1**	**0.3**	**0.6**
NET BOOK VALUE				
As at January 1, 2006	–	–	0.4	0.4
As at December 31, 2006	**0.8**	**0.5**	**1.1**	**2.4**

19.
LONG TERM DEBT AND FINANCING ARRANGEMENTS

	2006 $m	2005 $m
Subordinated loan note of €12.0 million	15.8	14.2
Subordinated loan note of €12.0 million	15.8	14.2
Subordinated loan note of $97.0 million	97.0	97.0
Carrying value and fair value	**128.6**	**125.4**

On December 15, 2005 the Group issued $97 million in aggregate principal amount of subordinated loan notes and €24 million in aggregate principal amount of subordinated loan notes ("long term debt") at an issue price of $1,000 and €1,000 of their principal amounts respectively.

The Euro subordinated loan notes are repayable on June 15, 2035 with a prepayment option available from March 15, 2011. Interest on the principal is based on a set margin (3.7%) above Euribor and is payable quarterly.

The US dollar subordinated loan notes are repayable on December 15, 2035 with a prepayment option available from March 15, 2011. This, like the Euro notes, only applies to a "special event" issue as defined in the transaction documents. Interest on the principal is based on a set margin (3.7%) above LIBOR and is payable quarterly.

The Group is exposed to cash flow interest rate risk and currency risk. Further information is provided in the risk disclosures section from page 41.

The interest accrued on the loans payable was $0.5 million (2005 – $0.4 million) at the balance sheet date.

Due to the floating interest rates, the carrying value approximates fair value.

LETTERS OF CREDIT

As both LICL and LICUKL are not admitted insurers or reinsurers throughout the U.S., the terms of certain contracts require them to provide letters of credit to policyholders as collateral. On May 17, 2006, LHL and LICL entered into a syndicated collateralised three year credit facility in the amount of $350 million. This facility is available for the issue of letters of credit ("LOCs") to ceding companies. The facility is also available for LICL to issue LOCs to LICUKL to collateralise certain insurance balances. It contains a $75 million loan sub-limit available for general corporate purposes. As at December 31, 2006, LICUKL had no such obligations. Letters of credit totalling $25.1 million had been issued to third parties by LICL and there was no outstanding debt under this facility.

20.
DERIVATIVE FINANCIAL INSTRUMENTS

The Group hedges a portion of its floating rate borrowings using interest rate swaps to transfer floating to fixed rate. These instruments are held at fair value through the consolidated income statement. During the period, $1.0 million (2005 – $nil) was charged to financing costs in respect of the interest rate swap. The net fair value position to the Group was $0.9 million (2005 – $nil). The Group has the right to net settle this instrument. The next cash settlement due on this instrument is negligible (2005 – $nil) and is due on March 15, 2007.

The Group invests a small portion of its investment portfolio in convertible debt securities. The option to convert is an embedded derivative, which is required to be separated from the host contract and fair valued through the consolidated income statement. As at December 31, 2006 the derivative instrument was valued at $11.5 million, with net unrealised gains of $1.8 million reflected in the consolidated income statement in other investment income.

21.
SHARE CAPITAL

AUTHORISED ORDINARY SHARES OF $0.50 EACH	Number	$m
As at December 31, 2005 and December 31, 2006	**3,000,000,000**	**1,500**

ALLOCATED, CALLED UP AND FULLY PAID	Number	$m
As at October 12, 2005 (date of incorporation)	–	–
Shares issued	195,713,902	97.9
As at December 31, 2005	**195,713,902**	**97.9**
Shares issued	113,219	–
Shares repurchased	(83,775)	–
As at December 31, 2006	**195,743,346**	**97.9**

LHL issued 16,000,000 new shares on October 27, 2005 as part of its initial capitalisation and launch. On December 9, 2005, LHL's outstanding shares were consolidated on a 5:1 basis into 3,200,000 shares. On December 16, 2005, an aggregate of 192,513,902 new shares were issued as part of LHL's private placement in the U.S. and initial public offering in the U.K., which included shares issued on the exercise of an over-allotment option. As a result of all the shares issued, a total of $978.6 million was raised, $97.9 million of which is included in share capital and $880.7 million of which was included in share premium, net of $19.9 million of offering expenses, formation expenses and warrants issued to management, founders and a sponsor. On December 28, 2006, 113,219 shares were issued and 83,775 repurchased as part of a cashless exercise of warrants (see note 22).

22.
WARRANTS AND OPTIONS

	Other warrants Number	Management ordinary warrants Number	Management performance warrants Number	Options Number
As at October 12, 2005 (date of incorporation)	–	–	–	–
Issued	25,417,136	12,708,695	7,625,218	–
Exercised	–	–	–	–
As at December 31, 2005	**25,417,136**	**12,708,695**	**7,625,218**	**–**
Issued	–	–	–	2,503,613
Forfeited	–	–	–	(101,670)
Exercised	(113,219)	–	–	–
As at December 31, 2006	**25,303,917**	**12,708,695**	**7,625,218**	**2,401,943**

22.
WARRANTS AND OPTIONS CONTINUED

WARRANTS

All warrants issued will expire on December 16, 2015 and are exercisable at an initial price per share of US$5.00 equal to the price per share paid by investors in the initial public offering. The warrant holder may request a cashless exercise. The method of settlement is at the discretion of the Group and may be in cash or shares.

FOUNDERS

The Group's founders provided industry expertise, resources and relationships during the fourth quarter of 2005. For the founders position and consideration, the Group issued warrants to certain founding shareholders to purchase in the aggregate, up to 17,791,919 common shares. These warrants were approved on December 9, 2005, dated December 16, 2005 and were fully vested and exercisable upon issuance.

On December 28, 2006 a founding investor exercised 113,219 warrants at a strike price of $5.00 per share. This was a cashless exercise and resulted in the Group issuing a further 29,444 common shares at $0.50 per share.

SPONSOR

In consideration for incorporation services received, warrants were issued to Benfield Advisory Limited to purchase 7,625,217 common shares. These warrants were granted on December 16, 2005 and were fully vested and exercisable upon issuance. On November 30, 2006 Benfield sold its entire holding of warrants to an unrelated third party.

Management warrants and options are discussed in note 6.

23.
LEASE COMMITMENTS

The Group has payment obligations in respect of operating leases for certain items of office equipment and office space. Operating lease expenses for the period were $1.1 million (2005 – $nil). Lease payments under non-cancellable operating leases are as follows:

	2006 $m	2005 $m
Due in less than one year	1.2	–
Due between one and five years	4.5	–
Due in more than five years	0.3	–
Total	**6.0**	**–**

24.
EARNINGS PER SHARE

Basic earnings or loss per share amounts are calculated by dividing net profit or loss for the period attributable to shareholders by the weighted average number of common shares outstanding during the year.

Diluted earnings or loss per share amounts are calculated by dividing the net profit or loss attributable to shareholders by the weighted average number of common shares outstanding during the year plus the weighted average number of common shares that would be issued on the conversion of all dilutive potential common shares into common shares.

The following reflects the profit (loss) and share data used in the basic and diluted loss per share computations:

	2006 $m	2005 $m
Profit (loss) for the period attributable to equity shareholders	159.3	(11.6)

	Number of shares (thousands)	Number of shares (thousands)
Basic weighted average number of shares	195,714	48,320
Potentially dilutive shares related to share-based compensation	6,325	5,733
Diluted weighted average number of shares	202,039	54,053

Share based payments are only treated as dilutive when their conversion to common shares would decrease earnings per share or increase loss per share from continuing operations. In the current period, incremental shares from the assumed exercising of management performance warrants are not included in calculating dilutive shares as the relevant criteria have not been met. In addition, the options are antidilutive and are therefore not included in the number of potentially dilutive shares.

In the prior period, incremental shares from the assumed exercising of warrants are not included in calculating the diluted earnings or loss per share as they are antidilutive.

25.
RELATED PARTY DISCLOSURES

The consolidated financial statements include Lancashire Holdings Limited and the subsidiaries listed below:

Name	Domicile
Lancashire Insurance Company Limited	Bermuda
Lancashire Insurance Marketing Services Limited	United Kingdom
Lancashire Holdings Financing Trust I	United States
Lancashire Insurance Holdings (UK) Limited	United Kingdom
Lancashire Insurance Company (UK) Limited (previously "Lancashire Insurance Services (UK) Limited")	United Kingdom
Lancashire Insurance Services Limited	United Kingdom

All subsidiaries are wholly owned, either directly or indirectly.

The Group has issued loan notes via a trust vehicle – Lancashire Holdings Financing Trust I (the "Trust") (see note 19). The Group effectively has 100% of the voting rights in the Trust. These rights are subject to the property trustee's obligations to seek approval of the holders of the Trust's preferred securities in case of default and other limited circumstances where the property trustee would enforce its rights. While the ability of the Group to influence the actions of the Trust is limited by the Trust Agreement, the Trust was set up by the Group with the sole purpose of issuing the loan notes and is in essence controlled by the Group, and is therefore consolidated.

KEY MANAGEMENT COMPENSATION

Remuneration for key management for the period ending December 31, 2006 was as follows:

	2006 $m	2005 $m
Short term compensation	4.5	–
Share based compensation	12.1	5.2
Total	**16.6**	**5.2**

TRANSACTIONS WITH DIRECTORS AND SHAREHOLDERS

Significant shareholders have a representation on the Board of Directors. During the period the Group paid $0.9 million (2005 – $nil) in directors' fees and expenses, including $0.4 million to significant shareholders. A further $0.3 million (2005 – $nil) was paid in respect of monitoring fees for significant shareholders pursuant to Monitoring Agreements, the terms of which are as disclosed in the AIM admission document.

TRANSACTIONS WITH ASSOCIATE

During the period the Group ceded $29.9 million (2005 – $nil) of premium to Sirocco and received $5.4 million (2005 – $nil) of commission income. As at December 31, 2006 the following amounts with Sirocco were included in our consolidated balance sheet:

	2006 $m	2005 $m
Unearned premium on premium ceded	11.8	–
Reinsurance payable	0.8	–
Deferred acquisition costs ceded	2.2	–

Profit commission is payable to the Group based on the performance of Sirocco over the period January 1, 2006 to July 15, 2008. The contingent profit commission as at December 31, 2006 was $2.6m (2005 – $nil).

TRANSACTIONS WITH SPONSOR

During the period the Group incurred net brokerage and consulting costs of $11.8 million with Benfield Group.

26.
NON-CASH TRANSACTIONS

Accrued formation expenses of $nil (2005 – $0.9 million) have been recorded directly in shareholders' equity. This amount represents a non-cash transaction and therefore is not included within the change in operational assets and liabilities in the consolidated cashflow statement.

On November 2, 2006, following shareholder approval, LHL transferred $850.0 million (2005 – $nil) from share premium to contributed surplus.

27.
STATUTORY REQUIREMENTS AND DIVIDEND RESTRICTIONS

As a holding company, LHL relies on dividends from its subsidiaries to provide cash flow required for debt service and dividends to shareholders. The subsidiaries' ability to pay dividends and make capital distributions is subject to the legal and regulatory restrictions of the jurisdiction in which they operate. For the primary operating subsidiaries these are based principally on the amount of premiums written and reserves for losses and loss expenses, subject to overall minimum solvency requirements. Statutory capital and surplus is different from shareholders' equity due to certain items that are capitalised under IFRS but expensed, have a different valuation basis, or are not admitted under insurance regulations.

Statutory capital and surplus reported to regulatory authorities by the primary operating subsidiaries is as follows:

As at December 31, 2006	$m	£m
	LICL	LICUKL
Statutory capital and surplus	1,079.2	56.3
Minimum required statutory capital and surplus	271.1	7.4

As at December 31, 2006	$m	£m
	LICL	LICUKL
Statutory capital and surplus	1,069.6	n/a
Minimum required statutory capital and surplus	100.0	n/a

28.
PRESENTATION

Certain amounts in the December 31, 2005 consolidated financial statements have been re-presented to conform with the current year's presentation and format. These changes in presentation have no effect on the previously reported net loss.

29.
SUBSEQUENT EVENTS

On February 25, 2007, LHL received notification from the Dubai Financial Services Authority that its application to operate an authorised insurance intermediation firm in Dubai had been approved in principle. The authorisation will be exercised via a wholly-owned subsidiary incorporated and operating within the Dubai International Financial Centre. The new subsidiary, called Lancashire Marketing Services (Middle East) Limited, will allow the Group to market its UK and Bermuda-based insurance subsidiaries more effectively and efficiently in the region.

ANNUAL GENERAL MEETING

Notice of this year's Annual General Meeting and the form of proxy accompany this annual report. If you have any queries regarding the notice or return of the proxy please contact Greg Lunn, (Company Secretary and General Counsel) at Lancashire, Mintflower Place, 8 Par-la-Ville Road, Hamilton HM 08, Bermuda, Tel: (441) 278 8953, Email: glunn@lancashire.bm.

FURTHER INFORMATION

Further information about the Group including this annual report and consolidated financial statements, press releases and the Company's share price is available on our website at **www.lancashire.bm**.

Certain statements and indicative projections made that are not based on current or historical facts are forward-looking in nature including without limitation, statements containing words "believes", "anticipates", "plans", "projects", "intends", "expects", "estimates", "predicts", "may", "will", "seeks", "should", or, in each case, their negative or comparable terminology. All statements other than statements of historical facts including, without limitation, those regarding the Group's financial position, results of operations, liquidity, prospects, growth, business strategy, plans and objectives of management for future operations (including development plans and objectives relating to the Group's insurance business) are forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause the actual results, performance or achievements of the Group to be materially different from future results, performance or achievments expressed or implied by such forward-looking statements. These factors include, but are not limited to: the number and type of insurance and reinsurance contracts that we write; the premium rates available at the time of such renewals within our targeted business lines; the absence of large or unusually frequent loss events; the impact that our future operating results, capital position and rating agency and other considerations have on the execution of any capital management initiatives; the possibility of greater frequency or severity of claims and loss activity than our underwriting, reserving or investment practices have anticipated; the reliability of, and changes in assumptions to, catastrophe pricing, accumulation and estimated loss models; loss of key personnel; a decline in our operating subsidiaries' rating with A.M. Best Company; increased competition on the basis of pricing, capacity, coverage terms or other factors; a cyclical downturn of the industry; changes in governmental regulations or tax laws in jurisdictions where Lancashire conducts business; Lancashire or its Bermudian subsidiary becoming subject to income taxes in the United States or the United Kingdom; and the effectiveness of our loss limitation methods.

These forward-looking statements speak only as at the date of publication of this document. Lancashire Holdings Limited expressly disclaims any obligation or undertaking (save as required to comply with any legal or regulatory obligations (including the AIM rules)) to disseminate any updates or revisions to any forward-looking statements to reflect any changes in the Group's expectations or circumstances on which any such statement is based.

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